ANDREA ELECTRONICS CORP
Form 10-Q
November 14, 2001

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, 2001

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 registrant as specified in its charter)

New York	11-0482020
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)
45 Melville Park Road, Melville, New York	11747
(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 the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of November 12, 2001, there are 16,233,968 common shares outstanding.

ITEM 1. FINANCIAL STATEMENTS

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

September 30, 2001

		(unaudited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$	4,782,414
Accounts receivable, net of allowance for doubtful accounts of $186,340 and $186,121		1,773,801
Inventories		6,128,324
Prepaid expenses and other current assets		430,321
Total current assets		13,114,860
PROPERTY AND EQUIPMENT, net		935,333
DEFERRED INCOME TAXES		1,806,615
GOODWILL		12,589,341
OTHER INTANGIBLE ASSETS		8,661,691
OTHER ASSETS		2,491,495
Total assets	$	39,599,335
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade accounts payable	$	1,737,274
Current portion of long-term debt		189,830
Other current liabilities		1,867,242
Total current liabilities		3,794,346
LONG-TERM DEBT		100,370
Total liabilities		3,894,716
SERIES B REDEEMABLE CONVERTIBLE PREFERRED STOCK, net, $.01 par value; authorized: 1,000 shares, issued and outstanding: 283 and 500 shares, respectively; liquidation value: $2,830,000 and $5,000,000, respectively		2,747,442
SERIES C REDEEMABLE CONVERTIBLE PREFERRED STOCK, net, $.01 par value; authorized: 1,500 shares, issued and outstanding: 750 shares; liquidation value: $7,500,000		7,356,688
SHAREHOLDERS' EQUITY:		
Preferred stock, $.01 par value; authorized: 4,997,500 shares; none issued and outstanding		--
Common stock, $.50 par value; authorized: 70,000,000 shares; issued and outstanding: 15,503,886 and 13,897,572 shares, respectively		7,751,943
Additional paid-in capital		55,661,922
Deferred stock compensation		(26,490)
Accumulated deficit		(37,786,886)
Total shareholders' equity		25,600,489

Total liabilities and shareholders' equity	$ 39,599,335

See Notes to Consolidated Financial Statements

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	For the Three Months Ended September 30,		For the Nine Mont September 3	
	2001	2000	2001	
NET SALES	$ 2,937,199	$ 5,318,936	$ 8,170,767	$
COST OF SALES	2,105,848	3,772,311	5,897,960	
Gross profit	831,351	1,546,625	2,272,807	
RESEARCH AND DEVELOPMENT EXPENSES	774,108	1,249,167	2,654,392	
GENERAL, ADMINISTRATIVE AND SELLING EXPENSES	2,117,360	2,389,736	6,739,458	
Loss from operations	(2,060,117)	(2,092,278)	(7,121,043)	
OTHER INCOME (EXPENSE):				
Interest income(expense)	(3,365)	21,208	117,505	
Other	(5,669)	25,632	20,220	
	(9,034)	46,840	137,725	
LOSS BEFORE PROVISION FOR INCOME TAXES	(2,069,151)	(2,045,438)	(6,983,318)	
PROVISION FOR INCOME TAXES	--	--	--	
Net loss	$ (2,069,151)	$ (2,045,438)	$ (6,983,318)	$
PREFERRED STOCK DIVIDENDS	140,755	60,577	430,653	
NON-CASH CHARGE ATTRIBUTABLE TO BENEFICIAL CONVERSION FEATURE	7,500,000	--	7,500,000	

Net loss attributable to common shareholders	$ (9,709,906)	$ (2,106,015)	$(14,913,971)	$
PER SHARE INFORMATION:				
Net Loss Per Share:				
Basic	$ (.64)	$ (.15)	$ (1.00)	$
Diluted	$ (.64)	$ (.15)	$ (1.00)	$
Shares used in computing net loss per share:				
Basic	15,137,578	13,836,893	14,848,707	
Diluted	15,137,578	13,836,893	14,848,707	

See Notes to Consolidated Financial Statements

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

For the Nine Months ended September 30, 2001

(UNAUDITED)

	Shares Outstanding	Common Stock	Additional Paid-In Capital	Deferre Stock Compensat
BALANCE, December 31, 2000	13,897,572	$ 6,948,786	$46,711,609	
Conversion of Series B Redeemable Convertible Preferred Stock, net of related costs	1,578,814	789,407	1,415,330	
Exercise of stock options, net of related costs	27,500	13,750	2,733	
Option grant to Consultant	--	--	32,250	(32,
Amortization of Deferred Stock Compensation	--	--	--	5,
Preferred stock dividends	--	--	--	
Non-cash charge attributable to beneficial conversion feature	--	--	7,500,000	
Net loss	--	--	--	
BALANCE, September 30, 2001	15,503,886	$ 7,751,943	$55,661,922	$ (26,

See Notes to Consolidated Financial Statements

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

	For the Nine Months Ended September 30, 2001	2000
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(6,983,318)	$(7,006,07
Adjustments to reconcile net loss to net cash used in operating activities:		
Non-cash interest expense	--	39,96
Non-cash stock compensation expense	5,760	-
Depreciation and amortization	2,707,094	2,633,94
(Increase) Decrease in:		
Accounts receivable, net	1,729,912	(1,022,44
Inventories	156,714	646,06
Prepaid expenses and other current assets	(719,418)	(420,43
Other assets	(447,375)	76
Increase (Decrease) in:		
Trade accounts payable	(370,386)	285,01
Other current and long term liabilities	245,143	(98,66
Net cash used in operating activities	(3,675,874)	(4,941,85
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(108,313)	(221,68
Net cash used in investing activities	(108,313)	(221,68
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments of debt obligations	(601,717)	(555,03
Payment of convertible notes	--	(1,485,07
Proceeds from issuance of common stock upon exercise of stock options, net of related costs	16,483	1,516,83
Net cash used in financing activities	(585,234)	(523,28
NET DECREASE IN CASH AND CASH EQUIVALENTS	(4,369,421)	(5,686,82
CASH AND CASH EQUIVALENTS, beginning of period	9,151,835	9,153,14
CASH AND CASH EQUIVALENTS, end of period	$ 4,782,414	$ 3,466,32
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Conversion of Series B Redeemable Convertible Preferred Stock and related accrued dividends into common stock	$ 2,204,740	$ 2,417,40
Option grant to consultant	$ 32,250	$ -

See Notes to Consolidated Financial Statements

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles 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 for any interim period are not necessarily indicative of the results 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, 2000.

2. Earnings Per Common Share - Basic net loss per common share is computed by dividing net loss by the weighted-average number of common shares outstanding. 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.

The following chart provides a reconciliation of information used in calculating the per share amounts:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2001	2000	2001	2000
Numerator:				
Net loss	$ (2,069,151)	$ (2,045,438)	$ (6,983,318)	$ (7,006,0
Preferred stock dividends	140,755	60,577	430,653	212,3
Non-cash charge attributable to beneficial conversion feature	7,500,000	--	7,500,000	
Net loss attributable to common shareholders	$ (9,709,906)	$ (2,106,015)	$(14,913,971)	$ (7,218,4
Denominator:				
Weighted-average common shares outstanding - Basic and Diluted*	15,137,578	13,836,893	14,848,707	13,702,9
Net loss per share - Basic and Diluted	$ (.64)	$ (.15)	$ (1.00)	$ (.

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* The effect of dilutive securities (stock options, Redeemable Convertible Preferred Stock and warrants) have not been included herein as their inclusion would be anti-dilutive.

3. Comprehensive Income - Andrea follows the provisions of SFAS No. 130, "Reporting Comprehensive Income", which requires companies to report all changes in equity during a

period, except those resulting from investment by owners and distribution to owners, in a financial statement for the period in which they are recognized. Comprehensive income is the total of net income (loss) and all other non-owner changes in equity (or other comprehensive income) such as unrealized gains/losses on securities available-for-sale, foreign currency translation adjustments and minimum pension liability adjustments. Comprehensive and other comprehensive income must be reported on the face of the annual financial statements or, in the case of interim reporting, in the footnotes to the financial statements. For the nine months ended September 30, 2001 and 2000, Andrea's operations did not give rise to items includible in comprehensive income (loss), which were not already included in net income (loss). Accordingly, Andrea's comprehensive loss is the same as its net loss for all periods presented.

4. Derivative Instruments - In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". This statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133, as by SFAS No. 137, was effective for Andrea on January 1, 2001. This statement requires the recognition of all derivative instruments as either assets or liabilities in the balance sheet measured at fair value. Derivative instruments will be recognized as gains or losses in the period of change. If certain conditions are met where the derivative instrument has been designated as a fair value hedge, the hedge items may also be marked to market through earnings, thus creating an offset. If the derivative is designed and qualifies as a cash flow hedge, the changes in fair value of the derivative instrument may be recorded in comprehensive income. While Andrea operates in international markets, it does so presently without the use of derivative instruments. Accordingly, the adoption of this statement as of January 1, 2001, did not have an effect.

5. In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, "Business Combinations" ("FAS 141") and No. 142, "Goodwill and Other Intangible Assets" ("FAS 142"). FAS 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under FAS 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). The amortization provisions of FAS 142, apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, Andrea is required to adopt FAS 142 effective January 1, 2002. Andrea is currently evaluating the effect that adoption of the provisions of FAS 142 will have on its results of operations and financial position.

6. Procurement Agreement - Andrea has an agreement with International Business Machines and its subsidiaries ("IBM") to produce and procure certain products, as defined. The agreement continues in full force and effect unless terminated earlier for material breach by either party, as defined. For the three month period ending September 30, 2001, sales of Andrea's products to IBM and certain of IBM's affiliates, distributors, licensees and integrators accounted for approximately 40% of Andrea's total net sales.

7. 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 (par value $0.01 per share) has a stated value of $10,000 plus dividends of 4% per annum, which sum is convertible into Common Stock (par

value $0.50 per share) at a conversion price equal to the lower of $8.775 (the "Maximum Conversion Price") and the average of the two lowest closing bid 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.

Any unconverted Series B Preferred Stock that remains outstanding on June 18, 2004 will automatically convert into Andrea's Common Stock. Andrea has reserved 8,876,355 shares of Common Stock for issuance upon conversion of the shares of the Series B Preferred Stock.

Upon the announcement of a major transaction, as defined in Andrea's Certificate of Incorporation, the investors have the right to require Andrea to redeem all or a portion of the investors' Preferred Shares at a redemption price equal to the greater of 120% of the stated value plus any accrued dividends or the Market Price on the day of announcement. In addition, upon the occurrence of certain triggering events, as defined, and depending on Andrea's control over such events, the investors may have the right to require Andrea to i) redeem all or a portion of the Preferred Shares at a redemption price equal to the greater of 120% of the stated value plus any accrued dividends or the Market Price on the day of announcement, or ii) pay a penalty equal to 1% of the remaining principal amount outstanding for a period not to exceed 20 days in any 365 day period, and adjust the Maximum Conversion Price, as defined.

Andrea engaged an investment banker to assist in obtaining additional capital and funding which if successful could involve the triggering of 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 waiver from the holders of the Series B Preferred Stock. If the Series B Preferred Stock holders do not consent to such a waiver, Andrea's efforts to obtain additional funding and capital will be materially adversely affected and its ability to continue its current operations will be materially adversely affected.

In the nine-month period ending September 30, 2001, the following number of shares of Series B Preferred Stock, together with related accrued dividends, were converted:

Date of Conversion	Number of Series B Preferred Stock Converted	Conversion Price	Number of Common Shares
January 11, 2001	100	$ 1.875	566,824
January 18, 2001	52	$ 1.875	294,961
August 16, 2001	65	$ .985	717,029
Total	217		1,578,814

As of September 30, 2001, the Series B Preferred Stock is recorded net of the unaccreted present value of the warrants of $82,558. Due to the redemption features described above, the Series B Preferred Stock is presented outside of stockholders' equity in the accompanying consolidated balance sheets.

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On November 2, 2001, 34 shares of the Series B Preferred Stock, together with related accrued dividends, were converted into 730,082 shares of Common Stock at a conversion price of $0.51.

8. 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 (par value $0.01 per share) has a stated value of $10,000 plus dividends of 5% per annum, which sum is convertible into Common Stock (par value $0.50 per share) 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 will be 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 current conversion price is $1.44. 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. Andrea has reserved 10,890,411 shares of Common Stock for issuance upon conversion of the shares of the Series B Preferred Stock. Andrea has the right to require the conversion of the Series C Preferred Stock after one year upon the satisfaction of certain conditions. During the eighteen-month period beginning on October 10, 2000, the investors may exercise an option to purchase up to an additional $2.5 million of Andrea's Series C Preferred Stock, subject to the closing bid price of Andrea's Common Stock being no less than $7.0565 as of the date of such exercise. These additional Preferred Shares would be identical in all material respects to those purchased at Initial Issuance and, consequently, a contingent beneficial

conversion feature exists which may result in the Investor obtaining a conversion price for such additional Preferred Shares which, at the time of the exercise of the option, could be less than the market price of the Common Stock at such date. In accordance with the provisions of Emerging Issues Task Force Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios", Andrea may be required to record, at the time of exercise for such additional Preferred Shares, a charge to accumulated deficit as a result of this beneficial conversion right.

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 Shares 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 the holder's delivery to Andrea of notice. In addition, if Andrea is unable to effect such redemption (i) interest will accumulate on the value of the Series C Preferred Shares that Andrea is unable to redeem at the rate of 2% per month and (b) the holders of the Series C Preferred Stock are entitled to void their redemption notices and receive a reset of their applicable conversion price.

Andrea engaged an investment banker to assist in obtaining additional capital and funding which if successful could involve the triggering of 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 waiver from the holders of the Series C Preferred Stock. If the Series C Preferred Stock

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holders do not consent to such a waiver, Andrea's efforts to obtain additional funding and capital will be materially adversely affected and its ability to continue its current operations will be materially adversely affected.

As of September 30, 2001, the Series C Preferred Stock is recorded net of unaccreted costs of $143,312. Due to the redemption features described above, the Series C Preferred Stock is presented outside of stockholders' equity in the accompanying consolidated balance sheet.

Furthermore, in accordance with EITF Issue 00-27, "Application of EITF Issue No. 98-5 to Certain Convertible Instruments", Andrea recorded a one time non-cash charge of $7,500,000 to accumulated deficit. 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 represents the maximum charge under this standard and, accordingly, there will be no additional charges to equity at later reset dates.

9. Acquisition Of Business - On May 5, 1998, Andrea acquired all of the outstanding shares of capital stock of Lamar (the "Acquisition"). The consideration paid by Andrea for the Acquisition was approximately 1,800,000 shares of restricted common stock, $1,000,000 in cash and $2,000,000 in notes payable. The cash was recorded at stated value. Both the notes payable and the shares issued were discounted to reflect the

appropriate value of the consideration paid taking into account the underlying restrictions, arriving at values of $1,615,000 and $23,129,532, respectively. Of the approximately 1,800,000 shares issued to the sellers, one-third became freely transferable on the first anniversary of the closing; an additional one-third became transferable on the second anniversary; and the last one-third on the third anniversary. Of the aggregate cash consideration to be paid by Andrea, $1,500,000, $500,000 and $500,000 was paid during 1998, 1999 and 2000, respectively, and the remaining $500,000 was paid on the thirty-six month anniversary of the closing (May 5, 2001). The Acquisition was accounted for under the purchase method of accounting and, accordingly, the operating results of Lamar have been included in the consolidating operating results since the date of acquisition. The purchase, for total aggregate consideration of $27.6 million, including costs associated with the acquisition of Lamar of $1.4 million, resulted in intangible assets of $27.3 million. The goodwill and other intangibles, together with their respective useful lives consist of the following as of September 30, 2001:

	Net Value at September 30, 2001	Estimated Useful Life
Goodwill	$12,589,341	15 years
Other Intangible Assets:		
Core Technology	$ 8,510,113	15 years
Workforce in Place	151,578	7 years
Total Other Intangible Assets	$ 8,661,691	

See Note 5 regarding new accounting pronouncement which relates to the amortization for Goodwill and Other Intangible Assets and is effective for financial statement periods beginning January 1, 2002.

10. 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

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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 three segments: (i) Andrea Anti-Noise Products, (ii) Aircraft Communications Products, and (iii) Andrea DSP Microphone and Software Products. The following represents selected consolidated financial information for Andrea 's segments for the three months ended September 30, 2001, and 2000:

	Andrea Anti-Noise	Aircraft Communications	Andrea D Microphone Softwar

Segment Data	Products	Products	Product
Net sales	$ 1,537,844	$ 1,201,895	$ 197,
Income (loss) from operations	(365,430)	250,098	(1,944,
Depreciation	98,612	27,720	50,

Segment Data	Andrea Anti-Noise Products	Aircraft Communications Products	Andrea Microphon Software P
Net sales	$ 4,560,017	$ 603,056	$ 15
Income (loss) from operations	652,886	(170,911)	(2,57
Depreciation	108,868	32,956	4

International revenues are based on the country in which the end-user is located. For the three months ended September 30, 2001 and 2000, sales and accounts receivable by geographic area are as follows:

Geographic Data	September 30, 2001	September 30, 2000
Sales:		
United States	$ 2,513,906	$ 3,960,340
Europe	136,783	487,129
Other foreign	286,510	871,467
	$ 2,937,199	$ 5,318,936
Accounts receivable:		
United States	$ 1,576,703	$ 2,447,034
Europe	102,702	719,147
Other foreign	94,396	626,964
	$ 1,773,801	$ 3,793,145

The assets and liabilities of the Company are managed centrally and are reported internally in the same manner as the consolidated financial statements, thus no additional information is produced for the Chief Executive or included herein.

11. Legal Proceedings - As previously reported in "Item 3. Legal Proceedings" in Andrea's Annual Report on Form 10-K for the year ended December 31, 2000, on November 17, 1998 a complaint was filed against Andrea in the U.S. District Court for the Eastern District of New York by NCT Group, Inc. ("NCT"; formerly Noise Cancellation Technologies, Inc.) and NCT Hearing Products, Inc., one of NCT's subsidiaries. The complaint involves two of Andrea's patents relating

to certain active noise reduction technology. Andrea does not currently derive significant sales or licensing revenue from this technology. The complaint requests a declaration that the two patents are invalid and unenforceable and that NCT's products do not infringe the patents. The complaint alleges that Andrea engaged in unfair competition by misrepresenting the scope of the two patents, tortuously interfering with prospective contractual rights between NCT and its existing and potential customers, making false and disparaging statements about NCT and its products, and falsely advertising certain of Andrea's technology. The complaint seeks to enjoin Andrea from engaging in these alleged activities and seeks compensatory damages of not less than $5,000,000, punitive damages of not less than $50,000,000 and plaintiffs' costs and attorneys' fees. Andrea filed and served an answer to the NCT complaint, denying the allegations and asserting various affirmative defenses and counterclaims. Andrea's counterclaims allege that NCT has willfully infringed the two patents, and that NCT has engaged in trademark infringement, false designation of origin, and unfair competition with respect to Andrea's mark ANR READY. The counterclaims seek injunctive relief with respect to the allegations of patent infringement, trademark infringement, false designation of origin and unfair competition. Andrea also seeks exemplary and punitive damages, prejudgment interest on all damages, costs, reasonable attorneys' fees and expenses. Andrea believes that, based upon the advice of outside legal counsel, NCT's allegations are without merit, and we intend to vigorously defend the claims described above.

In March 1999, Andrea was notified about a claim filed by the owners of property adjoining Andrea's Long Island City facility with respect to certain environmental matters. In September 1999, a complaint was filed in the Supreme Court of the State of New York, County of Nassau seeking $1 million in compensatory damages from Andrea. On September 27, 2001, Andrea was granted a motion for summary judgment, thereby dismissing the plaintiff's complaint in its entirety.

In addition to the litigation noted above, Andrea is from time to time subject to routine litigation incidental to its business. While it is not feasible to predict or determine the final outcome of the claims against Andrea, management believes that the results of the above noted litigation and other pending legal proceedings will not have a material adverse effect on Andrea's financial condition, results of operations or liquidity.

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

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

Overview

Andrea Electronics designs, develops and manufacturers state-of-the-art microphone technologies and equipment for enhancing speech-based applications software and communications that require high performance and high quality voice input.

Andrea's products and technologies optimize the performance of speech-based applications software in markets such as:

- voice communication over the Internet;

- speech recognition and dictation to desktop, laptop and hand-held computers;

- audio/video conferencing;
- computer-based automobile monitoring and control systems for use by drivers and passengers;
- Military and Commerical Aircraft Communications systems;
- electronic equipment for incorporation into home appliances and industrial and commercial office equipment that is activated and controlled by voice; and
- interactive games where one or more players participate over the Internet.

Our patented Active Noise Cancellation microphone and Active Noise Reduction earphone technologies help to ensure clear speech in personal computer and telephone headset applications. Active Noise Cancellation microphone technology uses electronic circuits that distinguish a speaker's voice from background noise in the speaker's environment and then cancels the noise from the signal to be transmitted by the microphone. Active Noise Reduction earphone technology uses electronic circuits that distinguish the signal coming through an earphone from background noise in the listener's environment and then reduces the noise heard by the listener. Together with our lower-end noise canceling headset products, these technologies and related products comprise our Andrea Anti-Noise line of business.

Our patented and patent-pending Andrea Digital Super Directional Array and Andrea Direction Finding and Tracking Array technologies enable the person speaking to be several feet from the microphone, and frees the speaker from having to hold the microphone (we refer to this capability as "far-field" microphone use). Our DSDA and DFTA microphone products convert sound received by the array of microphones in the product into digital signals that are then processed to cancel background noise from the signal to be transmitted. These two technologies represent the core technologies within our portfolio of far-field technologies. We are initially targeting our far-field microphone technologies at the market for personal computers designed for use in automobiles, trucks and buses to control sound systems, mobile telephones, satellite-based navigation systems, and other devices within vehicles. These technologies and related products comprise our Andrea Digital Signal Processing (DSP) Microphone and Software line of business.

In May 1998, we acquired Lamar Signal Processing, Ltd., an Israeli corporation engaged in the development of scalable, digital signal processing-based directional, noise cancellation microphone technologies, which included primarily DSDA and DFTA. The consideration paid by Andrea for Lamar was approximately 1,800,000 shares of restricted common stock, $1,000,000 in cash and $2,000,000 in notes payable. We recorded the cash at stated value. We discounted the value of the notes payable to $1,615,000 to reflect Andrea's borrowing rate as well as the time value of the payments on the notes, and we discounted the value of the shares to $23,129,532 to reflect, among other things, trading restrictions on the shares. We believe that the acquired technologies, together with the research staff at Lamar, provide Andrea with noise filtering capabilities and performance that is superior to other DSP-based technologies in the marketplace, and unattainable in traditional mechanical-based microphone solutions.

We are incorporated under the laws of the State of New York and have been engaged in the electronic communications industry since 1934. For several decades prior to our entry into the voice-activated computing market in the 1990's, our primary business was selling intercom systems for military and industrial use. We refer to this line of business as Aircraft Communications. We are seeking to apply our knowledge of the military and industrial markets to develop applications of our Andrea DSP Microphone and Software technologies.

The interim results of operations of Andrea presented in this report are not necessarily indicative of the actual sales or results of operations to be realized for the full year.

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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, 2001 (the "2001 Third Quarter") compared to the three months ended September 30, 2000 (the "2000 Third Quarter"), and for the nine months ended September 30, 2001 (the "2001 First Nine Months") compared to the nine months ended September 30, 2000 (the "2000 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," "seeks," 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:

Because 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 under our collaborative development arrangements;

- the mix of products we sell;

- the mix of distribution channels we use;

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

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

- general economic conditions.

We cannot assure that the level of 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 2001 Third Quarter were approximately $2.9 million compared to approximately $5.3 million in the 2000 Third Quarter. Net loss applicable to common shareholders for the 2001 Third Quarter, before giving effect to a special, one-time, non-cash accumulated deficit charge of $7.5 million, was approximately $2.2 million, or $0.15 per share on a diluted basis, compared to a net loss applicable to common shareholders of approximately $2.1 million, or $0.15 per share on a diluted basis, for the 2000 Third Quarter. Our revenues for the First Nine Months of 2001 were approximately $8.2 million compared to approximately $11.7 million in the First Nine Months of 2000. For the First Nine Months of 2001, we had a net loss

attributable to common shareholders, before giving effect to the special, one-time, non-cash equity charge, of approximately $7.4 million compared to a net loss attributable to common shareholders of $7.2 million in the First Nine Months of 2000. We have experienced a significant decline in headset unit shipments during the First Nine Months of 2001 compared to the First Nine Months of 2000, offset to an extent, by increases in aircraft communication revenues. In response to our declining revenues, we are examining opportunities for cost-reduction, production efficiencies and further diversification of our business. However, to remain competitive, we intend to continue incurring substantial research and development, marketing and general and administrative expenses. We may not be able to easily and quickly reduce these expenses if our sales revenue falls below our expectations and, therefore, our net income or loss may be disproportionately affected by any reduction in sales revenue. Furthermore, our acquisition in 1998 of Lamar Signal Processing, Ltd. resulted in a substantial amount of goodwill and other intangible assets. The amortization of these intangible assets has, and will continue to have, a negative, non-cash impact on our results of operations. Additionally, there could be a financial statement impact due to a new accounting pronouncement that is effective January 1, 2002, that could prompt us to write-off some portion of our goodwill and other intangible assets, change the amortization life or method of these assets or cessation of the amortization of some or all of our goodwill and other intangible assets (See Note 5 of the financial statement notes). As a result of these 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, 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.

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. Andrea engaged an investment banker to assist the in seeking additional capital and funding. 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. In the event that we are unsuccessful in raising additional capital or funding, our funding will be primarily reliant upon existing funding sources and gross cash flows from operations which are expected to be insufficient to maintain our operations at current levels. Additionally, Andrea's funding and capital raising efforts could trigger change in control payments due to certain executive officers of Andrea under their employment contracts.

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 70,000,000 shares of common stock presently authorized, 16,233,968 were outstanding as of November 12, 2001. This does not include 5,915,625 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. In addition, this does not include 19,766,766 shares of common stock reserved for issuance upon conversion of the Series B and Series C convertible preferred stock and exercise of related warrants. Furthermore, in May 1998, we issued 1,800,000 shares of common stock as part of the consideration for our acquisition of Lamar Signal Processing, Ltd. Trading restrictions on these 1,800,000 shares have expired and are subject to demand and piggyback registration rights. To date, 920,880 of the 1,800,000 shares have been registered for sale under the Securities Act of 1933.

Conversions of our Series B convertible preferred stock and Series C convertible preferred stock may result in substantial dilution to other holders of our common stock.

As of November 12, 2001, we had 249 shares of Series B convertible preferred stock and 750 shares of Series C convertible preferred stock outstanding. Both the Series B convertible preferred stock and the Series C convertible preferred stock are 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 B convertible preferred stock and Series C convertible preferred stock increases.

The variable conversion price of the Series B convertible preferred stock and any reset of the conversion price of the Series C convertible preferred stock are functions 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 the varying amounts of shares of common stock issuable upon conversion of all 249 shares of Series B Convertible Preferred Stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 4% additional amount is paid in cash:

Conversion Price	Number of Shares of Common Stock Issuable Upon Conversion(1)	Percentage of Outstan Common Stock(2)
$0.50	4,980,000	23%
$1.50	1,660,000	9%

$2.50	996,000	6%
$3.50	711,429	4%
$4.50	553,333	3%
$5.50	452,727	3%
$6.50	383,077	2%
$7.50	332,000	2%

(1) The Series B Holder is prohibited from converting its holdings of the Series B convertible 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 16,233,968 shares of common stock outstanding as of November 12, 2001.

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 750 shares of Series C convertible preferred stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 5% additional amount is paid in cash:

Conversion Price	Number of Shares of Common Stock Issuable Upon Conversion(1)	Percentage of Outstan Common Stock(2)
$0.40	18,750,000	54%
$0.55	13,636,364	46%
$0.70	10,714,286	40%

$0.85	8,823,529	35%
$1.00	7,500,000	32%
$1.30	5,769,231	26%
$1.44	5,208,333	24%

(1) The Series C Holder is prohibited from converting its holdings of the Series C convertible 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 16,233,968 shares of common stock outstanding as of November 12, 2001.

The following table illustrates the varying amounts of shares of Common Stock that would be issuable upon conversion of all 249 outstanding shares of Series B convertible preferred stock and all 750 outstanding shares of Series C convertible preferred stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that all additional amounts are paid in cash:

Conversion Price	Number of Shares of Common Stock Issuable Upon Conversion(1)(2)(3)	Percentage of Outstan Common Stock(4)
$0.50	19,980,000	55%
$1.00	9,990,000	38%
$1.44	6,937,500	30%
$2.50	6,204,333	28%
$3.50	5,919,762	27%
$4.50	5,761,667	26%
$5.50	5,661,061	26%
$6.50	5,591,410	26%
$7.50	5,540,333	25%

(1) The calculation assumes that the conversion price of the Series B and Series C convertible preferred stock are the same at the assumed conversion prices of $.50, $1.00 and $1.44. This could only occur if the market price of Andrea's Common Stock declines, and at a future reset date, the conversion price of the Series C adjusts to the then prevailing market price (the current fixed conversion price of the Series C is $1.44, and such conversion price is fixed unless adjusted downward at a future reset date).

(2) The calculation assumes that for any conversion of the Series B convertible preferred stock when the prevailing market price is above $1.44, the Series C would still be converted at its maximum conversion price of $1.44.

(3) The Series B and Series C holder is prohibited from converting the Series C or Series B convertible preferred stock, or from exercising the warrants issued in connection with the Series B convertible 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.

(4) Based on 16,233,968 shares of common stock outstanding as of November 12, 2001.

Sales of an increased number of shares of common stock issued upon conversion of the Series B convertible preferred stock and the Series C convertible 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 B convertible preferred stock and the Series C convertible 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 B convertible preferred stock and the Series C convertible 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 B convertible preferred stock and Series C convertible 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 B and Series C convertible 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 Anti-Noise and Andrea Digital Signal Processing Microphone and Software products, our revenues may not increase at a high enough rate to improve our results of operations or at all.

Our business, results of operations and financial condition depend on successful commercialization of our Andrea Anti-Noise and Andrea DSP Microphone and Software products and technologies. Since we began sales of the initial Andrea Anti-Noise products in 1995, we have been expanding the number of products in this line. We introduced our first Andrea Digital Super Directional Array products in 1998 and we are initially targeting these and our other Andrea DSP Microphone and Software products at the market for computer-based automobile monitoring and control systems for use by drivers and passengers. This market is commonly referred to as the automobile telematics market. The success of these products is subject to the risks frequently encountered by companies in an early stage of product commercialization, particularly companies in the computing and communications industries.

If we are unable to obtain market acceptance of our voice interface and Internet communications 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 Anti-Noise and Andrea DSP Microphone and Software products and our Aircraft Communication 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.

In the markets for our Aircraft Communications products, we often compete with major defense electronics corporations as well as smaller manufacturing firms, which specialize in supplying products and technologies for specific military initiatives.

Further, the markets for our products and technologies are characterized by evolving industry standards and specifications that may require us to devote substantial time and expense to adapt our products and technologies. 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 those of their products with which our products are included or incorporated, our sales growth could be adversely affected.

We have entered into several collaborative and distribution arrangements with software publishers and computer hardware manufacturers relating to the marketing and sale of Andrea Anti-Noise products and Andrea DSP Microphone and 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 those of 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.

If we fail to maintain sales of Andrea Anti-Noise products and Andrea DSP Microphone and Software products to IBM, we would experience a material adverse effect on our business, results of operations and financial condition.

We are substantially dependent on our product procurement relationship with IBM. During the 2001 Third Quarter, IBM and certain of IBM's affiliates, distributors, licensees and integrators accounted for 40% of our net sales. This represents an approximate 63% decrease from the 2000 Third Quarter. While we are a party to a procurement agreement with IBM covering the purchase by IBM of certain of our Andrea Anti-Noise microphone and earphone products for inclusion with certain of IBM's personal computer products, IBM is not obligated to purchase these products and is free to purchase microphone and earphone products and technologies from our competitors. Our failure to maintain sales of Andrea Anti-Noise Products and Andrea DSP Microphone and Software Products to IBM would have a material adverse effect on our business, results of operations and financial condition.

If we fail to maintain sales of Aircraft Communication Products to the U.S. Government, we would experience a material adverse effect on our business, results of operations and financial condition.

We are substantially dependent on product sales to the U.S. Government. During the 2001 First Nine Months, the U.S. Government accounted for 20% of our net sales. The U.S. Government is not obligated to continue to purchase these products and is free to purchase similar products from our competitors. Our failure to maintain sales of Aircraft Communication Products to the U.S. Government would have a material adverse effect on our business, results of operations and financial condition.

Shortages of, or interruptions in, the supply of more specialized components for our Andrea Anti-Noise products and Andrea DSP Microphone products could have a material adverse effect on our sales of these products.

We conduct assembly operations at our facilities in New York and Israel and through subcontractors using purchased components. Some specialized components for the Andrea Anti-Noise and Andrea DSP Microphone products, such as microphones and digital signal processing boards, are available from a limited number of suppliers and subject to long lead times. We may not be able to continue to obtain sufficient supplies of these more specialized components, particularly if our sales of Andrea Anti-Noise and Andrea DSP microphone products increase substantially or market demand for these components otherwise increases.

If our subcontractor fails to meet our production and shipment schedules, our business, results of operations and financial condition would be materially and adversely affected.

We conduct assembly operations at our facilities in New York and Israel and through subcontracting. During initial production runs of Andrea Anti-Noise and Andrea DSP Microphone products, we perform assembly operations at our New York facility from purchased components. As sales of any particular product increase, assembly operations are primarily transferred to a subcontractor in Asia.

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.

On November 17, 1998 a complaint was filed against us in the U.S. District Court for the Eastern District of New York by NCT Group, Inc. and NCT Hearing Products, Inc., one of NCT's subsidiaries, requesting a declaration that two of our patents, which relate to active noise reduction technology applicable to aircraft passenger headphones, are invalid and unenforceable and that these patents are not being infringed by NCT's products. The complaint also seeks to enjoin us from engaging in certain

alleged activities and seeks compensatory damages of not less than $5 million, punitive damages of not less than $50 million and plaintiffs' costs and attorneys' fees.

On December 30, 1998, we filed and served an answer to the NCT complaint, denying the allegations and asserting affirmative defenses and counterclaims. The counterclaims seek injunctive relief for patent infringement, trademark infringement, false designation of origin and unfair competition. We are also seeking exemplary and punitive damages, prejudgment interest on all damages, costs, reasonable attorneys' fees and expenses. During the third quarter of 2001, the court held an early hearing on the meaning of the claims in the two Andrea patents. This type of hearing is called a "Markman Hearing." We are unable to anticipate when the court will issue a decision on this question. We and NCT are proceeding with discovery, including document production and depositions. If this suit is ultimately resolved in favor of NCT, we could be materially adversely effected. We believe, however, that NCT's allegations are without merit and we intend to vigorously defend ourselves and to assert against NCT the claims described above.

On March 11, 1999, we were notified about a claim filed with the New York State Environmental Protection and Spill Compensation Fund by the owners (Mark J. Mergler and Ann Mergler) of property adjoining our former Long Island City facility. This claim alleges property damages arising from petroleum migrating from our former facility and was purportedly detected in the basement of the claimants' property. In their claim to the fund, the claimants alleged that their property has been damaged and that they have incurred remedial costs. In the event the fund honors this claim in whole or in part, we may be liable to reimburse the fund. The New York State Department of Environmental Conservation has asserted a demand that we investigate and remediate the discharge of petroleum from a fuel oil storage tank at our former Long Island City facility, and determine whether the petroleum discharge has migrated to the claimants' adjoining property.

We engaged environmental consultants to investigate the discharge from the fuel oil storage tank and we are currently funding remediation work. We denied, however, the allegations that any petroleum discharge has migrated to the claimant's property and objected to the claim made by the claimant to the fund. On September 2, 1999, a civil action related to this matter was commenced in the Nassau County Supreme Court by Mark J. Mergler and Ann Mergler. The plaintiffs alleged that the fuel oil released from the heating system of our former facility has migrated beneath and onto the neighboring property causing in excess of $1,000,000 in direct and consequential damages. The plaintiffs' allegations against us included, negligence, nuisance and strict liability under the New York State Navigation Law. On September 27, 2001, Andrea was granted a motion for summary judgment, thereby dismissing the plaintiff's complaint in its entirety.

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

We have been seeking to increase our sales to regions outside the United States, particularly in Europe and areas in the Americas and Asia. For the 2001 Third Quarter, sales to customers outside the United States accounted for approximately 14% of our net sales. 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 continue to be able to invoice all our sales in U.S. dollars and 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, as of September 30, 2001, certain of our key research and development employees were 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 additional highly qualified managers and technical personnel. 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, 2001 Compared to the Quarter Ended September 30, 2000

Sales

Sales for the 2001 Third Quarter were $2,937,199, a decrease of 45% from sales of $5,318,936 for the 2000 Third Quarter. Sales for the 2001 First Nine Months were $8,170,767, a decrease of 30% from the 2000 First Nine Months sales of $11,701,688. The decrease in sales for the 2001 Third Quarter reflects an approximate 66% decrease in sales of Andrea Anti-Noise Products to $1,537,844, or 52% of total sales, offset by an approximate 99% increase in sales of our Aircraft Communications Products, to $1,201,895, or 41% of total sales, and an approximate 27% increase of Andrea DSP Microphone and Software Products to $197,460, or 7% of total sales. The decline of Andrea Anti-Noise Products was due, primarily, to a significant decrease in headset unit shipments to IBM and certain of its affiliates, distributors, licensees and integrators which is primarily a result of increased competition in the PC headset market, coupled with unfavorable economic conditions which continues to negatively impact the technology sector. The increase in our Aircraft Communication Product revenues is primarily a result of increased sales and marketing activities. For the 2001 Third Quarter, sales of our computer headsets to IBM and certain of its affiliates, distributors, licensees and integrators accounted for approximately 40% of our total sales; sales of our Aircraft Communication Products to the U.S. Government accounted for approximately 14% of our total sales.

Cost of Sales

Cost of sales as a percentage of sales for the 2001 Third Quarter increased to 72% from 71% for the 2000 Third Quarter. Cost of sales as a percentage of sales for the 2001 First Nine Months decreased to 72% from 73% for the 2000 First Nine Months. These slight changes are primarily due to the product mix of revenues for each respective period, as described under "Sales" above.

Research and Development

Research and development expenses for the 2001 Third Quarter decreased 38% to $774,108 from $1,249,167 for the 2000 Third Quarter. Research and development expenses for the 2001 First Nine Months were $2,654,392, a decrease of 24% from the 2000 First Nine Months research and development expenses of $3,488,839. These decreases are due primarily to a reduction in expenses associated with research efforts that were determined not to be integral to Andrea's core portfolio of digital microphone software and hardware technologies. DSP Microphone and Software Technology efforts were $610,595, or 79% of total research and development expenses, Aircraft Communications technology efforts were $78,937, or 10% of total research and development expenses and Andrea Anti-Noise Product efforts were $84,576, or 11% of total research and development expenses. With respect to DSP Microphone and Software Technologies, research efforts are primarily focused on the pursuit of commercializing a natural language-driven human/machine interface by developing optimal far-field microphone solutions for various voice-driven interfaces, incorporating the

Company's digital super directional array microphone technology ("DSDA") and certain other related technologies obtained through the acquisition of Lamar in May 1998. The Company believes that the acquisition of Lamar significantly reinforces its position in digital signal processing by extending the Company's marketing programs to other high-growth industries, including automotive telematics, mobile device markets, the business videoconferencing market and Internet telephony, among others. Specifically, the core technology acquired produces noise filtering capabilities that management believes is preferred to other known DSP-based technologies in the market, and is unattainable in products using traditional mechanical solutions. In addition, the nature of a DSP-based solution, together with the people acquired supporting our technology, offers a solution that is highly scalable and embeddable, and therefore enables the technology to be integrated into many different applications and form factors. We believe that continued research and development spending will provide the Company with a competitive advantage.

General, Administrative and Selling Expenses

General, administrative and selling expenses for the 2001 Third Quarter decreased 11% to $2,117,360 from $2,389,736 for the 2000 Third Quarter. General, administrative and selling expenses for the 2001 First Nine Months were $6,739,458 a decrease of less than 1% from the 2000 First Nine Months general, administrative and selling expenses of $6,784,391. These decreases are primarily due to management's cost reduction plan, which is aimed at cutting costs that are not integral to the execution of the Company's overall strategy, and to ensure conservative spending during the current period of economic uncertainty. Included in the Company's cost reduction initiatives was a reduction in workforce which was implemented during February of 2001, representing a reduction of approximately 25% of the Company's then total workforce.

Other Income (Expense)

Other expense for the 2001 Third Quarter was $9,034 compared to other income of $46,840 for the 2000 Third Quarter. Other income for the 2001 First Nine Months was $137,725 compared to other income of $103,309 for the 2000 First Nine Months. The decline in the 2001 Third Quarter compared to the 2000 Third Quarter is a result of significant unfavorable market conditions for our invested cash balances (which were also lower) experienced in the 2001 Third Quarter. Alternatively, the increase in the 2001

First Nine Months compared to the 2000 First Nine Months is due to a net favorable rate increase experienced during the 2001 First Nine Months compared to the 2000 First Nine Months.

Provision for Income Taxes

The Company did not record income tax expense for the 2001 Third Quarter or 2001 First Nine Months in light of the net loss recorded for the periods. Furthermore, the realization of a portion of the Company's reserved deferred tax assets, if and when realized, will not result in a tax benefit in the consolidated statement of operations, but will result in an increase in additional paid in capital as they are related to tax benefits associated with the exercise of stock options. The Company will be continually re-assessing its reserves on deferred income tax assets in future periods on a quarterly basis. The determination as to the realization of additional reserves is, and will be, based on Andrea's expectations of future earnings. To the extent Andrea's management believes that, more likely than not, previously reserved deferred tax assets will be realized, Andrea will reduce the reserve accordingly.

Net Income (Loss)

Net loss for the 2001 Third Quarter was $2,069,151 compared to a net loss of $2,045,438 for the 2000 Third Quarter. Net loss for the 2001 First Nine Months was $6,983,318, compared to net loss of $7,006,072 for the 2000 First Nine Months. The levels of net loss for the 2001 Third Quarter and 2001 First Nine Months principally reflect the factors described above.

Liquidity And Capital Resources

The Company'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 or potential industry partners. At September 30, 2001, we had cash and cash equivalents of $4,782,414 compared with $9,151,835 at December 31, 2000. The balance of cash and cash equivalents at September 30, 2001 is primarily a result of the Company's issuance and sale in a private placement of $7,500,000 of its Series C Redeemable Convertible Preferred Stock (the "Series C Preferred Stock"). The Company is using the net proceeds from the issuance of the Series C Preferred Stock primarily for costs associated with:

1) research and development,

2) creating and maintaining strategic alliances, which includes, among other things, sales and marketing salaries, substantial travel costs to market our products and technologies, product fulfillment costs and technical assistance, and other general support costs for existing and potential partners,

3) payment of certain debt obligations,

4) professional fees, and

5) general working capital requirements.

In connection with the acquisition of Lamar, of the aggregate cash consideration to be paid by the Company, $1,000,000 was paid on May 5, 1998, the closing date, and $500,000 was paid on each of the six, twelve, twenty-four and thirty-six month anniversaries of the closing date. The final payment was paid on May 5, 2001.

Working capital at September 30, 2001, was $9,320,514 compared to $15,035,051 at December 31, 2000. The decrease in working capital reflects decreases in total current assets and total current liabilities of $6,046,985, and $332,448, respectively. The decrease in total current assets reflects decreases in cash and cash equivalents of $4,369,421, a decrease in accounts receivable of $1,729,912, and a decrease in inventory of $156,714 partially offset by increase in prepaid expenses and other current assets of $209,062. The decrease in current liabilities reflects a decrease in trade accounts payable of

$370,386 and a decrease in current portion of long-term debt of $486,216, offset, in part, by an increase in other current liabilities of $524,154.

The decrease in cash from December 31, 2000 to the period ending September 30, 2001 of $4,369,421 reflects $3,675,874 of net cash used in operating activities, $108,313 of cash used in investing activities and $585,234 of cash used in financing activities.

The cash used in operating activities, excluding non-cash charges, is primarily attributable to the $6,983,318 net loss for the 2001 First Nine Months, a $1,729,912 decrease in accounts receivable, $156,714 decrease in inventory, $719,418 increase in prepaid and other current assets , a $444,375 increase in other assets, a $370,386 decrease in accounts payable, a $245,143 increase in other current and long term liabilities. The increase in prepaid expenses and other current assets primarily includes the recognition of increased premiums for prepaid property taxes and insurance, as well as increases in other service costs related to the remainder of 2001. The decrease in accounts payable as well as the decrease in inventory primarily reflect differences in the timing related to both the payments for and the acquisition of raw materials as well as for other services in connection with ongoing efforts related to the Company's various product lines.

The cash used in investing activities is attributable to capital expenditures consisting of manufacturing dies and molds and, to a lesser extent, upgrades in the Company's existing computer systems.

The cash used in financing activities reflects the payment of the thirty-six month anniversary installment payment to the former shareholders of Lamar, partially offset by exercises of employee stock options.

The Company believes that it is necessary to raise additional working capital to support operations. In December 1995, April 1996, August 1996 and June 1998, the Company raised working capital through the issuance of convertible subordinated debentures. In June 1999, the Company raised $7.5 million through the issuance and sale of Series B Preferred Stock. In October 2000, the Company raised $7.5 million through the issuance and sale of Series C Preferred Stock. Furthermore, in accordance with EITF Issue 00-27, "Application of EITF Issue No. 98-5 to Certain Convertible Instruments", Andrea recorded a one time non-cash charge of $7,500,000 to accumulated deficit. 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 represents the maximum charge under this standard and, accordingly there will be no additional charges to equity at later reset dates. The Company has incurred significant losses in each of the last three fiscal years. In the nine month period ended September 30, 2001, the Company incurred losses from operations of $7.1 million and used $3.7 million in its operating activities. Management expects that operating losses and negative cash flows will continue at least through Fiscal 2001 as the Company continues to market its Andrea Anti-Noise products, Aircraft Communication products and Andrea Digital Signal Processing Microphone and Software Technologies. Management anticipates that existing sources of liquidity and anticipated revenue will satisfy projected working capital and other cash requirements through the first quarter of Fiscal 2002 and the Company is seeking additional capital and funding with the assistance of an investment banker. If the Company fails to develop revenues from sales of its products to generate adequate funding from operations or fails to obtain additional financing through capital or funding, it will be required to either further reduce its operating expenses and/or operations or may result it relinquishing its products, technologies or markets. Such financing may not be available on acceptable terms, or at all. Notwithstanding the significance of sales of Andrea Anti-Noise Products as a percentage of our total sales during 2001, we cannot assure that demand will continue for these products or any of our other products, including future products related to our Andrea Digital Signal Processing Microphone and Software Technologies, or, that if such demand does exist, that we will be able to obtain the necessary working capital to increase production and marketing resources to meet such demand on favorable terms, or at all.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our principal source of financing activities is the issuance of convertible debt with financial institutions. We are affected by market risk exposure primarily through any amounts payable in stock, or cash by us under convertible securities. A significant rise in interest rates could materially adversely affect our financial condition and results of operations. We do not utilize derivative financial instruments to hedge against changes in interest rates or for any other purpose. In addition, substantially all transactions by us are denominated in U.S. dollars. As such, we have shifted foreign currency exposure onto our foreign customers. As a result, if exchange rates move against foreign customers, we could experience difficulty collecting unsecured accounts receivable, the cancellation of existing orders or the loss of future orders. The foregoing could materially adversely affect our business, financial condition and results of operations.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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 11 to the unaudited financial statements in this quarterly report for a discussion of the legal proceedings of the Company.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

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

None

(b) Reports on Form 8-K

The registrant did not file any reports on Form 8-K during the three-month period ended September 30, 2001.

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SIGNATURES

Pursuant to the requirements of Section 13 and 15(d) of the Exchange Act, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ANDREA ELECTRONICS CORPORATION

/s/ Christopher P. Sauvigne ----------------------------- Christopher P. Sauvigne	Chief Executive Officer and President	November 14, 2001
/s/ Richard A. Maue ----------------------------- Richard A. Maue	Executive Vice President, Chief Financial Officer, and Secretary	November 14, 2001