

Edgar Filing: ANDREA ELECTRONICS CORP - Form 10-Q

ANDREA ELECTRONICS CORP  
Form 10-Q  
November 14, 2002

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, 2002

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

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ANDREA ELECTRONICS CORPORATION

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(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  
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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  No

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Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes \_\_\_ No X

Indicate the number of shares outstanding of each of the registrant's classes of common equity, as of the latest practicable date: As of November 12, 2002, there are 20,043,864 common shares outstanding.

### ITEM 1. FINANCIAL STATEMENTS

#### ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS

		Septemb
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		(unaud
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$	4
Accounts receivable, net of allowance for doubtful accounts of \$70,848 and \$176,292		
Inventories		3
Prepaid expenses and other current assets		-----
Total current assets		9
PROPERTY AND EQUIPMENT, net		
DEFERRED INCOME TAXES		
GOODWILL		12
INTANGIBLE ASSETS		8
OTHER ASSETS		-----
Total assets		\$ 31
		=====
LIABILITIES, REDEEMABLE SECURITIES, AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade accounts payable	\$	
Current portion of long-term debt		
Accrued restructuring charges		
Deferred revenue		1
Other current liabilities		2
Total current liabilities		5
LONG-TERM DEBT		
DEFERRED REVENUE		2
OTHER LIABILITIES		-----
Total liabilities		8

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COMMITMENTS AND CONTIGENCIES

SERIES B REDEEMABLE CONVERTIBLE PREFERRED STOCK, net, \$.01 par value; authorized: 1,000 shares; issued and outstanding: 86 and 249 shares, respectively; liquidation value: \$860,000 and \$2,490,000, respectively

SERIES C REDEEMABLE CONVERTIBLE PREFERRED STOCK, net, \$.01 par value; authorized: 1,500 shares; issued and outstanding: 750 shares; liquidation value: \$7,500,000

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: 20,011,948 and 16,308,968 shares, respectively

Additional paid-in capital

Deferred stock compensation

Accumulated deficit

Total shareholders' equity

Total liabilities, redeemable securities, and shareholders' equity

See Notes to Condensed Consolidated Financial Statements

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

	For the Three Months Ended	
	September 30,	
	2002	2001
REVENUES		
Net product revenues	\$1,009,676	\$2,937,199
License revenues	360,353	-
Total revenues, net	\$1,370,029	\$2,937,199
COST OF SALES	671,631	2,105,848
Gross profit	698,398	831,351
RESEARCH AND DEVELOPMENT EXPENSES	884,772	774,108
GENERAL, ADMINISTRATIVE AND SELLING EXPENSES	1,391,966	2,117,360

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Loss from operations	(1,578,340)	(2,060,117)
OTHER (EXPENSE) INCOME:		
Interest (expense) income, net	(30,756)	(3,365)
Other	14,809	(5,669)
	(15,947)	(9,034)
LOSS BEFORE PROVISION FOR INCOME TAXES	(1,594,287)	(2,069,151)
PROVISION FOR INCOME TAXES	1,806,615	-
Net loss	\$ (3,400,902)	\$ (2,069,151)
PREFERRED STOCK DIVIDENDS	115,328	140,755
NON-CASH CHARGE ATTRIBUTABLE TO BENEFICIAL CONVERSION FEATURE	-	7,500,000
Net loss attributable to common shareholders	\$ (3,516,230)	\$ (9,709,906)
PER SHARE INFORMATION:		
Net Loss Per Share:		
Basic and Diluted	\$ (.18)	\$ (.64)
Shares used in computing net loss per share:		
Basic and Diluted	19,216,925	15,137,578

See Notes to Condensed Consolidated Financial Statements

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ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

For the Nine Months Ended September 30, 2002

(UNAUDITED)

	Shares Outstanding	Common Stock	Addition Paid-In Cap
	-----	-----	-----
BALANCE, January 1, 2002	16,308,968	\$8,154,484	\$54,642,5
Conversions of Series B Redeemable Convertible Preferred Stock, net of related costs	3,365,480	1,682,740	91,4

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Preferred stock dividends	-	-	(357,8
Employee Stock Grant	337,500	168,750	60,7
Option Grant to Consultants	-	-	42,2
Amortization of deferred stock compensation	-	-	-
Amortization of Option Grant to Consultants	-	-	-
Net loss	-	-	-
	-----	-----	-----
BALANCE, September 30, 2002	20,011,948	\$10,005,974	\$54,479,1
	=====	=====	=====

	Accumulated Deficit	Total Shareholders' Equity
	-----	-----
BALANCE, January 1, 2002	\$ (43,455,971)	\$19,288,750
Conversions of Series B Redeemable Convertible Preferred Stock, net of related costs	-	1,774,190
Preferred stock dividends	-	(357,854)
Employee Stock Grant	-	-
Option Grant to Consultants	-	-
Amortization of deferred stock compensation	-	200,589
Amortization of Option Grant to Consultants	-	27,588
Net loss	(6,822,146)	(6,822,146)
	-----	-----
BALANCE, September 30, 2002	\$ (50,278,117)	14,111,117
	=====	=====

See Notes to Condensed Consolidated Financial Statements

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

For the N  
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2002  
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### CASH FLOWS FROM OPERATING ACTIVITIES:

Net loss	\$(6,822,146)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:	
Non-cash stock compensation expense	228,177
Depreciation and amortization	936,081
Deferred income taxes	1,806,615
Change in:	
Accounts receivable, net	1,535,288
Inventories, net	(227,401)
Prepaid expenses and other current assets	149,155
Other assets	72,151
Trade accounts payable	(187,395)
Accrued restructuring charges	(111,131)
Deferred revenue	3,463,314
Other current and long-term liabilities	567,476
Net cash provided by (used in) operating activities	1,410,184

### CASH FLOWS FROM INVESTING ACTIVITIES:

Purchases of property and equipment	(132,686)
Patents and trademarks	(146,882)
Net cash used in investing activities	(279,568)

### CASH FLOWS FROM FINANCING ACTIVITIES:

Payments of debt obligations	(143,376)
Proceeds from issuance of common stock upon exercise of stock options, net of related costs	-
Net cash used in financing activities	(143,376)

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	987,240
CASH AND CASH EQUIVALENTS, beginning of period	3,724,130
CASH AND CASH EQUIVALENTS, end of period	\$ 4,711,370

### 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	\$ 1,774,190
Stock grant to employees	\$ 229,500
Option grant to consultant	\$ 42,400

See Notes to Condensed Consolidated Financial Statements

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

These unaudited, condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and accordingly, they do not include all of the information and footnotes normally provided in annual financial statements.

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, revenues and expenses reported in those financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

Management Estimates - Among other things, estimates are used in accounting for allowances for bad debts, inventory obsolescence, restructuring reserves, product warranty, depreciation, deferred income taxes, expected realizable values for assets (primarily goodwill and intangible assets), contingencies, revenue recognition as well as the recording and presentation of our convertible preferred stock. Estimates and assumptions are periodically reviewed and the effects of any material revisions are reflected in the consolidated financial statements in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

Andrea believes that adequate disclosures are made to keep the information fairly presented. 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, 2001.

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

Revenue Recognition - Non software-related revenue is recognized upon shipment. Andrea reports such sales levels on a net sales basis, with net sales being computed by deducting from gross sales, the amount of actual sales returns and the amount of reserves established for anticipated returns. With respect to license revenues, Andrea recognizes revenue in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended, and Staff Accounting Bulletin ("SAB") No. 101 "Revenue Recognition in Financial Statements." License revenue is recognized based on the terms and conditions of individual contracts (see Note 10). In addition, fee-based services are performed on a time-and-material basis or on a fixed-fee basis, under separate service arrangements.

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2. Deferred Tax Assets - Statement of Financial Accounting Standards ("SFAS") No. 109 "Accounting for Income Taxes" ("FAS 109") requires that a valuation allowance be established when it is "more likely than not" that all or a portion of deferred tax assets will not be realized. A review of all available positive and negative evidence needs to be considered, including a company's performance, the market environment in which the company operates, the length of carryback and carryforward periods, and expectations of future profits, etc.

FAS 109 further states that forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Therefore, cumulative losses weigh heavily in the overall assessment. Pursuant to a change in circumstances during the third quarter, which caused a change in our judgment regarding the realizability of deferred tax assets, and after considering all other positive and negative evidence (including, in particular, cumulative losses in recent years) available to us at September 30, 2002, we concluded that it was appropriate to record a full valuation allowance against our net deferred tax assets. As a

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result, we recorded an additional valuation allowance of \$1.8 million for the quarter ended September 30, 2002. In addition, we expect to provide a full valuation allowance on future tax benefits until we can sustain a level of profitability that demonstrates our ability to utilize the assets, or other significant positive evidence arises that suggests our ability to utilize such assets.

3. Earnings Per Common Share - Basic net loss per common share is computed by dividing net loss attributable to common shareholders by the weighted-average number of common shares outstanding. Diluted net loss per common share is computed by dividing net loss attributable to common shareholders 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,		
	2002	2001	2002
<b>Numerator:</b>			
Net loss	\$(3,400,902)	\$(2,069,151)	\$(6,822,1
Preferred stock dividends	115,328	140,755	357,8
Non-cash charge attributable to beneficial conversion feature	-	7,500,000	-
	\$ (3,516,230)	\$ (9,709,906)	\$ (7,180,0
<b>Denominator:</b>			



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Weighted-average common shares outstanding - Basic and Diluted/*/	19,216,925 =====	15,137,578 =====	18,356,2 =====
Net loss per share - Basic and Diluted	\$ (.18) =====	\$ (.64) =====	\$ (. =====

\*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.

4. In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations" ("FAS 141") and No. 142, "Goodwill and Other Intangible Assets" ("FAS 142"). FAS 141 requires all business combinations initiated after September 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). Andrea has adopted FAS 142 effective January 1, 2002, and accordingly, those intangible assets that continue to be classified as goodwill or as other intangibles with indefinite lives are no longer amortized. Other intangible assets, which do not have indefinite lives (such as core technology), continue to be amortized. As of January 1, 2002, we made an assessment of our intangible assets to identify goodwill separately from other identifiable intangibles. No adjustment was deemed necessary, although

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the intangible asset "Workforce in Place", which amounted to \$141,029, was reclassified as goodwill. In accordance with FAS 142, intangible assets, including purchased goodwill, is evaluated annually for impairment, or more often if circumstances warrant. We performed initial transitional impairment testing of goodwill and intangible assets during the first quarter of fiscal 2002. That effort, and preliminary assessments of our identifiable intangible assets, indicated that little or no adjustment would be required upon adoption of this pronouncement. The impairment testing is performed in two steps: (step one) the determination of impairment, based upon the fair value of a reporting unit as compared to its carrying value, and (step two) if there is an impairment, this step measures the amount of impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. FAS 142 required that an entity complete step one of the transitional goodwill impairment test within six months of adoption, and that if there is an indication that the carrying amount of the net assets of a reporting unit exceeds its fair value, step two must be completed by the end of the fiscal year. In the second quarter of fiscal 2002, we determined that the carrying value of this unit might be greater than its fair value. In order to finalize our determination of fair value, we will require the assistance of a third-party valuation firm. We anticipate completing this analysis during the fourth quarter of 2002.

The following table presents adjusted net loss and net loss per share data restated to include the pro forma retroactive impact of the adoption of FAS 142:

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Three Months Ended  
September 30,

	2002	2001	2000
Reported Net Loss attributable to common shareholders	\$ (3,516,230)	\$ (9,709,906)	\$ (7,100,000)
Goodwill and Workforce in Place Amortization	-	282,047	-
Adjusted Net Loss	\$ (3,516,230)	\$ (9,427,859)	\$ (7,100,000)
Net Loss Per Share - Basic and Diluted	\$ (.18)	\$ (.64)	\$ (.23)
Goodwill and Workforce in Place Amortization	-	.02	-
Adjusted Net Loss Per Common Share	\$ (.18)	\$ (.62)	\$ (.23)
Weighted-average common shares outstanding - Basic and Diluted	19,216,925	15,137,578	18,300,000

The changes in the carrying amount of Goodwill and Intangible assets during the nine months ended September 30, 2002 were as follows:

	Goodwill	Core Technology	Trademarks and Patents
Balance as of December 31, 2001	\$12,317,843	\$ 8,326,587	\$ 502,334
Additions during the period	-	-	146,882
Reclassifications	141,029	-	-
Amortization	-	(550,581)	(27,574)
Balance as of September 30, 2002	\$12,458,872	\$ 7,776,006	\$ 621,642

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Intangible assets as of September 30, 2002 and December 31, 2001 consisted of the following:

	September 30, 2002	December 31, 2001
Core Technology	\$7,776,006	\$8,326,587
Trademarks and Patents	621,642	502,334

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Workforce in Place	-	141,029
	-----	-----
Total Intangible Assets	\$8,397,648	\$8,969,950
	=====	=====

Amortization of core technology is expected to be approximately \$734,000 a year for the next 11 years. Trademarks and Patents are amortized using the straight-line method over 17 years.

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

	September 30, 2002	December 31, 2001
	-----	-----
Raw materials	\$ 2,308,079	\$ 2,000,375
Work-in-process	294,381	130,167
Finished goods	1,794,629	1,845,720
	-----	-----
	4,397,089	3,976,262
Less: reserve for obsolescence	(779,959)	(586,533)
	-----	-----
	\$ 3,617,130	\$ 3,389,729
	=====	=====

6. New Accounting Pronouncements - In August 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supersedes SFAS No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" and Accounting Principles Board Opinion No. 30 "Reporting Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." The Statement retains the fundamental provisions of SFAS No. 121 for recognition and measurement of impairment, but amends the accounting and reporting standards for segments of a business to be disposed of. The provisions of this statement are required to be adopted no later than fiscal years beginning after December 31, 2001. The impact of adopting this standard was not material to the financial statements.

On April 30, 2002 the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 63, Amendments of FASB Statement No. 13, and Technical Corrections" ("FAS 145"). FAS 145 eliminates the requirement that gains and losses from the extinguishment of the debt be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect and eliminates an inconsistency between the accounting for sale-leaseback transactions and certain lease modifications that have economic effects that are similar to sale-leaseback transactions. Generally, FAS 145 is effective for transactions occurring after May 15, 2002. The adoption of this standard is expected to have no impact to Andrea.

SFAS No. 146, " Accounting for Costs Associated with Exit of Disposal Activities" ("FAS 146"), provides guidance on the recognition and

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measurement of liabilities for cost associated with the exit of disposal activities. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002. Andrea is currently reviewing FAS 146 to determine the impact upon adoption.

7. Restructuring Accrual - During the fourth quarter of fiscal 2001, Andrea recorded restructuring charges in connection with exiting a PC headset channel, or customer-type, within the Anti-Noise Headset Product segment. The restructuring charge was recorded as accrued restructuring charges or as a reduction of assets, as applicable. During the first nine months of fiscal 2002, we made payments of \$111,131, which reduced the restructuring

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liability that had been established during the fourth quarter of fiscal 2001. As of September 30, 2002, there were no material revisions to the plan, exit costs, or the anticipated timing of our plan's execution.

8. Series B Redeemable Convertible Preferred Stock - On September 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 has a stated value of \$10,000 plus dividends of 4% per annum, which sum is convertible into Common Stock at a conversion price equal to the lower of \$8.775 (the "Maximum Conversion Price") and the average of the two lowest trade prices of the Common Stock during the 15 consecutive trading days immediately preceding a conversion date (the "Market Price"), subject to certain adjustments, including anti-dilution. The 4% dividends may, at the option of Andrea, be paid in cash. The warrant has an exercise price of \$8.775 per share and expires on June 18, 2004.

All of the Series B Preferred Stock is currently convertible into Andrea's Common Stock, and Andrea has reserved 3,560,152 shares of Common Stock for issuance upon conversion.

Upon the announcement of a major transaction, as defined in Andrea's Certificate of Incorporation, the holders of the Series B Preferred Stock have the right to require Andrea to redeem all or a portion of the holders' Series B Preferred Stock 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, and depending on Andrea's control over such events, the holders of Series B Preferred Stock may have the right to require Andrea to (i) redeem all or a portion of the Series B Preferred Stock 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.

Andrea is actively seeking to obtain 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

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affected.

In the nine-month period ended September 30, 2002, 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
-----	-----	-----
January 11, 2002	40	\$0.59
March 15, 2002	37	\$0.51
May 22, 2002	52	\$0.655
September 17, 2002	34	\$0.415
	--	
Total	163 ===	

The original value of the warrants upon issuance was \$348,457. As of September 30, 2002, the Series B Preferred Stock is recorded net of the unaccreted present value of the warrants of \$20,454. Due to the redemption features described above, the Series B Preferred Stock is presented outside of shareholders' equity in the accompanying condensed consolidated balance sheets.

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9. 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 reset every six months thereafter to the lesser of the then existing conversion price or the average of the two lowest closing bid prices of the Common Stock during the 5 consecutive trading days immediately preceding the six-month reset dates or, for the period beginning on the day two years after the initial issuance and ending on the maturity of the Series C Preferred Stock, the least of: (i) the then existing conversion price, (ii) the average of the two lowest closing bid prices of the Common Stock during the 15 consecutive trading days immediately preceding such two year date or (iii) the closing bid price on the day of conversion, subject in each case to certain adjustments. The 5% dividend amount may, at the option of Andrea, be paid in cash or in shares of Andrea's Common Stock. The Series C Preferred Stock is convertible or redeemable at maturity by Andrea, based upon certain circumstances at that time, and is redeemable by the holder upon certain events. As of September 30, 2002, all of the Series C Preferred Stock is currently convertible into Andrea's Common Stock, and Andrea has reserved 10,890,411 shares of Common

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Stock for issuance upon conversion of the shares of the Series C Preferred Stock. On October 10, 2002, 81.24% of one share of the Series C Preferred Stock was converted into 31,916 shares of Common Stock at a conversion price of \$0.28.

In accordance with EITF Issue 00-27, "Application of EITF Issue No. 98-5 to Certain Convertible Instruments", in the third quarter of 2001, Andrea recorded a non-cash charge of \$7,500,000 to 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 represented the maximum charge under this standard.

The original value of the transaction costs upon issuance was \$175,000. As of September 30, 2002, the Series C Preferred Stock is recorded net of the unaccreted present value of the transaction costs of \$116,385. Due to the redemption features discussed above, the Series C Preferred Stock is presented outside of shareholders' equity in the accompanying condensed consolidated balance sheet.

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

On March 15, 2002, Andrea announced that a triggering event had occurred and that as a result of the trigger, the investor had the right to require Andrea to redeem all of the Series C Preferred Stock. The investor has agreed, in a Waiver Agreement, to waive its right to receive the aggregate Triggering Event Redemption Price (as defined in the Certificate of Amendment) (together with any interest and related cash payments or penalties thereon) the investor was otherwise entitled to as a result of the existing triggering event until April 7, 2007. In addition, the investor agreed to waive, until April 7, 2007, its right to receive the aggregate triggering event Redemption Price, as defined, (together with any interest and related cash payments or penalties thereon) with respect to (1) any future triggering event relating to additional registration failures, provided that the existing registration statements remain effective and available to the investor for the number of shares covered by such registration statements as of the date of the waiver (less any future sales made pursuant to such registration statements), and (2) any future Triggering Event relating to the delisting of Andrea's Common Stock, provided that the Common Stock is thereafter authorized for trading on the OTC Bulletin Board. In addition, the investor agreed to waive, until April

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obligation to make certain cash payments, if any, for its failure to register any additional shares. Finally, the investor acknowledged that no Maturity Date Redemption Price (as defined) was due on October 10, 2002. The investor's waivers described above shall be null and void immediately, however, upon the earlier of April 7, 2007, if such Triggering Event Redemption Price is not paid on April 7, 2007, the first date on which Andrea fails to comply in any material respect with the terms of the Waiver Agreement, and related agreements entered into between Andrea and the investor (the "Agreements"), and the first date on which Andrea is insolvent.

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

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

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

10. In December 2001 and March 2002, Andrea entered into two agreements with Analog Devices, Inc. ("Analog Devices"). These license agreements relate to Andrea's high performance noise canceling technologies that enable clear voice communications and high-performance audio in small home-office and regular office environments. Under our agreements with Analog Devices, they paid us a total of \$5 million in license fees during the first nine months of 2002. The unamortized portion of the license agreements, as amended, is recorded as deferred revenue (\$1,666,680 of which is classified as current and \$2,796,634 classified as long-term as of September 30, 2002) in the accompanying condensed consolidated balance sheets. All license revenues are being recognized on a straight-line basis over three-years, \$3 million of which started to be recognized during the first quarter of 2002, and \$2 million which started in the third quarter of 2002.

### 11. Commitments And Contingencies-

Leases - Andrea's corporate headquarters is located in Melville, New York, where Andrea leases space for manufacturing, research and development, sales and executive offices from an unrelated party. The lease is for

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approximately 40,000 square feet and expires in June 2008. For the three months and nine months ended September 30, 2002, rent expense under this operating lease was approximately \$148,000 and \$435,000, respectively. As of September 30, 2002, the minimum future lease commitments, under this lease and all other noncancellable operating leases, are as follows:

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2002 (fourth quarter of 2002)	\$	192,954
2003		768,195
2004		744,021
2005		657,530
2006		683,832
Thereafter		1,050,375
-----		
Total	\$	4,096,907
=====		

Legal Proceedings - As previously reported in Andrea's Annual Report on Form 10-K for the year ended December 31, 2001, Andrea was engaged in a lawsuit filed in the U.S. District Court for the Eastern District of New York by NCT Group, Inc. ("NCT") and its subsidiary NCT Hearing Products, Inc. Andrea filed and served an answer to the NCT complaint, denying the allegations and asserting affirmative defenses and counterclaims. Effective July 29, 2002, Andrea executed a non-cash settlement of the lawsuit with NCT which dismissed both NCT's claims and Andrea's counterclaims.

12. Segment Information- Andrea follows the provisions of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("FAS 131"). Performance measurement and resource allocation for our reportable segments are based on many factors. The primary financial measure is income (loss) from operations, which includes the revenues, costs and expenses directly attributable to each segment, as well as an allocation of costs and operating expenses, which are not managed at a segment level, but are shared services such as, for example, general corporate functions and corresponding costs that are determined to be related to the products or services sold for each segment. Income (loss) from operations for our segments excludes any provision for income taxes. Reportable operating segments are determined based on Andrea's management approach. The management approach, as defined by FAS 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 our 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 Headset Products, (ii) Aircraft Communications Products, and (iii) Andrea DSP Microphone and Audio Software Products. The following represents selected consolidated financial information for Andrea's segments for the three months ended September 30, 2002, and 2001:

Andrea DSP  
Microphone



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Segment Data	Andrea Anti- Noise Headset Products	Aircraft Communications Products	and Audio Software Products
Net sales	\$519,254	\$347,116	\$503,659
Income (loss) from operations	25,077	(54,685)	(1,548,732)
Depreciation	41,175	23,177	43,631

Segment Data	Andrea Anti- Noise Headset Products	Aircraft Communications Products	Andrea DSP Microphone and Audio Software Products
Net sales	\$1,537,844	\$1,201,895	\$197,460
Income (loss) from operations	(365,430)	250,098	(1,944,785)
Depreciation	98,612	27,720	50,756

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The following represents selected consolidated financial information for Andrea's segments for the nine months ended September 30, 2002, and 2001:

Segment Data	Andrea Anti- Noise Headset Products	Aircraft Communications Products	Andrea DSP Microphone and Audio Software Products
Net sales	\$1,772,156	\$2,171,450	\$996,073
Income (loss) from operations	(350,312)	320,698	(5,006,751)
Depreciation	132,172	72,103	153,651

Segment Data	Andrea Anti- Noise Headset Products	Aircraft Communications Products	Andrea DSP Microphone and Audio Software Products
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Net sales	\$4,030,262	\$3,542,012	\$598,493
Income (loss) from operations	(1,861,075)	1,137,319	(6,397,287)
Depreciation	299,982	100,605	165,835

International revenues are based on the country in which the end-user is located. For the three months ended September 30, 2002 and 2001, sales and accounts receivable by geographic area are as follows:

Geographic Data	September 30, 2002	September 30, 2001
-----	-----	-----
Sales:		
United States	\$ 1,238,137	\$ 2,513,906
Europe	60,526	136,783
Other foreign	71,366	286,510
	-----	-----
	\$ 1,370,029	\$ 2,937,199
	=====	=====
Accounts receivable:		
United States	\$ 433,492	\$ 1,576,703
Europe	60,871	102,702
Other foreign	64,495	94,396
	-----	-----
	\$ 558,858	\$ 1,773,801
	=====	=====

For the nine months ended September 30, 2002 and 2001, sales by geographic area are as follows:

Geographic Data	September 30, 2002	September 30, 2001
-----	-----	-----
Sales:		
United States	\$ 4,223,722	\$ 6,549,833
Europe	239,420	506,755
Other foreign	476,537	1,114,179
	-----	-----
	\$ 4,939,679	\$ 8,170,767
	=====	=====

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The assets and liabilities of Andrea 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.

13. Concentration of Credit Risk - Sales of Andrea Anti-Noise Headset products

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to one customer and its affiliates were approximately 2% and 40% of the total sales for the 2002 and 2001 third quarter, respectively, and 7% and 29% for the 2002 and 2001 first nine months, respectively. Sales to the federal government and related subcontractors were approximately 6% and 14% of the total sales for the 2002 and 2001 third quarter, respectively, and 18% and 20% for the 2002 and 2001 first nine months, respectively.

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

#### Overview of Our Products, Technologies and Markets

We design, develop and manufacture state-of-the-art microphone technologies and products for enhancing speech-based applications software and communications that require high quality, clear voice signals. Our technologies eliminate unwanted background noise to enable the optimum performance of various speech-based and audio applications.

Andrea's products and technologies optimize the performance of speech-based applications and audio applications in primarily the following markets:

- . personal computing (primarily for speech recognition applications and voice communication over the Internet);
- . audio and video conferencing;
- . in-vehicle communications (to enable untethered, hands-free communication);
- . military and commercial aircraft communications systems; and
- . call centers.

Our patented and patent-pending digital noise canceling technologies enable a speaker to be several feet from the microphone, and free 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 an array of microphones in a product into digital signals that are then processed to cancel background noise from the signal to be transmitted. These two adaptive technologies represent the core technologies within our portfolio of far-field technologies. In addition to DSDA and DFTA, Andrea has developed and commercialized several other digital, far-field noise canceling technologies, including, among others, Andrea EchoStop, a high-quality acoustic echo canceller, and Andrea PureAudio, a leading technology for canceling unwanted stationary noises. All of our digital, far-field microphone technologies are software-based and operate using either a dedicated DSP or a general purpose processor (for example, the Pentium) and the software, which may encompass one or all of our far-field noise canceling technologies, can be applied to improve the performance of a single microphone or multiple microphones. In addition, our digital, far-field, noise canceling technologies can be tailored and implemented into various form factors, for example, into the monitor of a PC, a rear view mirror, or a personal digital assistant, and can be used individually or combined depending on particular customer requirements. We are currently targeting our far-field technologies primarily at 1) the desktop computing market (primarily through our relationship with Analog Devices, Inc.), 2) the market for personal computers designed for use in automobiles, trucks and buses to control satellite-based navigation systems and other devices within vehicles, 3) the market for mobile devices, such as a personal digital assistants and 4) the military and commercial aircraft communication systems market. Our far-field, digital noise canceling technologies and related products, together with implementations of other high-end audio technologies (for example, our Active Noise Reduction

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technology), comprise our Andrea Digital Signal Processing (DSP) Microphone and Audio Software line of business,

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and sales of such technologies and products during the Third Quarter 2002 and the Third Quarter 2001 approximated 37% and 7%, respectively, of our total net revenues. We dedicate the majority of our marketing and research and development resources to this business segment, as we believe that communication products will increasingly require high performance, untethered (hands-free and headset-free) microphone technology.

Our headset microphone products help to ensure clear speech in personal computer and telephone headset applications. Our 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. Our Active Noise Reduction headphone products use 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 and our call center headset products that we launched during 2002, these products comprise our Andrea Anti-Noise Headset line of business. During the fourth quarter 2001, we recorded restructuring charges relating to repositioning our business plan for our Andrea Anti-Noise Headset Product business segment as part of our overall effort to drive high margin product sales and become profitable. The restructuring focused on exiting from an increasingly unprofitable PC OEM/retail headset channel within Andrea's Anti-Noise Headset product segment. This was primarily a result of the increasing competitive nature of the PC headset market, coupled with Andrea's ongoing strategic efforts to focus on being primarily a supplier of digital, far-field noise canceling microphone technologies. This PC OEM/retail headset channel primarily purchased our lower-end, low margin headset products, and required substantial support which, when combined with decreasing volumes realized during 2001, became unprofitable. During the Third Quarter 2002 and the Third Quarter 2001 our Andrea Anti-Noise Headset Product segment approximated 38% and 52%, respectively, of our total net revenues.

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 aircraft communications. During 2000 and 2001, we dedicated development efforts aimed at increasing the manufacturability of certain intercom products as well as to accommodate future implementation of our digital, far field noise canceling technologies. We refer to this line of business as our Aircraft Communications line of business, and sales of such products during the Third Quarter 2002 and Third Quarter 2001 approximated 25% and 41%, respectively, of our total net revenues.

We are incorporated under the laws of the State of New York and have been engaged in the electronic communications industry since 1934.

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.

### Our Critical Accounting Policies

Our condensed consolidated financial statements and the notes to our condensed consolidated financial statements contain information that is pertinent to management's discussion and analysis. The preparation of financial

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statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities. In addition to the recording and presentation of our convertible preferred stock, we believe that the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operations. We have discussed the application of these critical accounting policies with our Audit Committee.

Revenue Recognition - Non license-related revenue is recognized upon shipment. Andrea reports such sales levels on a net sales basis, with net sales being computed by deducting from gross sales the amount of actual sales returns and the amount of reserves established for anticipated returns. With respect to license revenues, Andrea recognizes revenue in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended, and Staff Accounting Bulletin ("SAB") No. 101 "Revenue Recognition in Financial Statement." In addition, fee-based services are performed on a time-and-material basis or on a fixed-fee basis, under separate service arrangements. We recognize license-related revenues primarily based on an evaluation of the terms of individual

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contracts (see Note 10 of our condensed consolidated financial statements, for example) considering, specifically, whether 1) significant obligations remain, 2) evidence of an arrangement exists, 3) the fees are fixed or determinable, and 4) collectibility is reasonably assured.

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

Inventory - We are required to state our inventories at the lower of cost or market. In assessing the ultimate realization of inventories, we are required to make considerable judgments as to future demand requirements and compare that with our current inventory levels. Our reserve requirements generally increase as our projected demand requirements decrease due to market conditions, technological and product life cycle changes as well as longer than previously expected usage periods. We experienced significant inventory charges in 2001 due to our change in strategic direction resulting, in part, from declining market conditions. In connection with our restructuring effort, we incurred inventory charges of approximately \$2.6 million during fiscal 2001. Inventories of approximately \$3.6 million at September 30, 2002, are net of reserves of approximately \$780 thousand. It is possible that additional charges to inventory may occur in the future if there is further declines in market conditions, or if additional restructuring actions are taken.

Statement of Financial Accounting Standards, or SFAS, No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("FAS 144") supersedes SFAS No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("FAS 121") and Accounting Principles Board Opinion No. 30 "Reporting Results of Operations - Reporting the Effects

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of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions". FAS 144 retains the fundamental provisions of FAS 121 for recognition and measurement of impairment, but amends the accounting and reporting standards for segments of a business to be disposed of. The provisions of this statement require management judgments regarding the future operating and disposition plans for marginally performing assets, and estimates of expected realizable values for assets to be sold. The impact of adopting this standard was not material to the financial statements.

Under SFAS No. 141, "Business Combinations", and SFAS No. 142, "Goodwill and Other Intangible Assets" ("FAS 142") 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). Andrea has adopted this standard effective January 1, 2002, and, accordingly, those intangible assets that continue to be classified as goodwill or as other intangibles with indefinite lives are no longer amortized. The adoption of this pronouncement, to date, resulted in a \$846 thousand decrease in amortization expense for the first nine months of 2002 over the same period in the prior year. Other intangible assets, which do not have indefinite lives, continue to be amortized. Andrea has made an assessment of its intangible assets to identify goodwill separately from other identifiable intangibles. Andrea determined no adjustment was necessary, although the intangible asset "Workforce in Place" is reclassified as goodwill pursuant to FAS 142. We performed initial transitional impairment testing of goodwill and intangible assets during the first quarter of fiscal 2002. That effort, and preliminary assessments of our identifiable intangible assets, indicated that little or no adjustment would be required upon adoption of this pronouncement. The impairment testing is performed in two steps: (step one) the determination of impairment, based upon the fair value of a reporting unit as compared to its carrying value, and (step two) if there is an impairment, this step measures the amount of impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. FAS 142 required that an entity complete step one of the transitional goodwill impairment test within six months of adoption, and that if there is an indication that the carrying amount of the net assets of a reporting unit exceeds its fair value, step two must be completed by the end of the fiscal year. In the second quarter of fiscal 2002, we determined that the carrying value of our Andrea DSP Microphone and Audio segment might be

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greater than its fair value. In order to finalize our determination of fair value, we will require the assistance of a third-party valuation firm. We anticipate completing this analysis during the fourth quarter of 2002.

**Deferred Tax Assets** - We currently have significant deferred tax assets. SFAS No. 109, "Accounting for Income Taxes" ("FAS 109"), requires a valuation allowance be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. Furthermore, FAS 109 provides that it is difficult to conclude that a valuation allowance is not needed when there is negative evidence such as cumulative losses in recent years. Therefore, cumulative losses weigh heavily in the overall assessment. Accordingly, and after considering recent changes in existing positive evidence, we recorded a full valuation allowance against our deferred tax assets during the third quarter ended September 30, 2002, recognizing a \$1.8 million, non-cash charge. In addition, we expect to provide a full valuation allowance on future

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

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

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

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

### Cautionary Statement Regarding Forward-Looking Statements

Certain information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations for the three months ended September 30, 2002 (the "2002 Third Quarter") compared to the three months ended September 30, 2001 (the "2001 Third Quarter") and for the nine months ended September 30, 2002 (the "2002 First Nine Months") compared to the nine months ended September 30, 2001 (the "2001 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

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could cause them to differ materially from those expressed in any such forward-looking statements. These factors include the following:

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;
- the cost of development of our products;
- the mix of products we sell;
- the mix of distribution channels we use;
- the timing of our new product releases and those of our competitors;
- fluctuations in the computer and communications hardware and software marketplace;
- fluctuations in Department of Defense spending/funding; and
- general economic conditions.

We cannot assure that the level of sales and gross profit, if any, that we achieve in any particular period will not be significantly lower than in other periods. Our revenues for the 2002 Third Quarter, were approximately \$1.4 million compared to approximately \$2.9 million in the 2001 Third Quarter. Net loss applicable to common shareholders for the 2002 Third Quarter was approximately \$3.5 million, or \$0.18 per share on a diluted basis, versus net loss applicable to common shareholders of approximately \$9.7 million, or \$0.64 per share on a diluted basis, for the 2001 Third Quarter. In the 2001 Third Quarter there was a special, one-time, non-cash accumulated deficit charge of \$7.5 million. Our revenues for the 2002 First Nine Months were approximately \$4.9 million compared to approximately \$8.2 million in the 2001 First Nine Months. For the 2002 First Nine Months, we had a net loss attributable to common shareholders of approximately \$7.2 million, or \$0.39 per share on a diluted basis compared to a net loss attributable to common shareholders of \$14.9 million, or \$1.00 per share on a diluted basis in the 2001 First Nine Months.

Because of increased competition and a shift in business strategy, 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.

In response to significant declines in our sales of Andrea Anti-Noise Headset Products as a result of increased competition with respect to a specific customer channel, as well as our overall shift in strategic direction to primarily deliver digital, far-field microphone solutions, during the fourth quarter of 2001, we recorded restructuring charges of approximately \$4.5 million. This restructuring is expected to result in further decreases in sales, on a comparable period basis, during the remainder of fiscal 2002. We are examining additional opportunities for cost-reduction, production efficiencies and further diversification of our business. But to remain competitive, we intend to continue incurring substantial research and development, marketing and



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general and administrative expenses. We may not be able to easily and quickly reduce these expenses if our sales revenue continues to fall below our expectations and, therefore, our net income or loss may be disproportionately affected by any further reduction in sales revenue. Furthermore, amortization of our intangible assets has had, and will continue to have, a negative, non-cash impact on our results of operations (other than goodwill). As a result of these factors, we expect to continue to accumulate losses and the market price of our common stock could decline.

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If we fail to obtain additional capital or maintain access to funds sufficient to meet our operating needs, we may be required to significantly reduce, sell, or refocus our operations and our business, results of operations and financial condition could be materially and adversely effected, and could result in our delisting from the American Stock Exchange or inability to continue operations.

In recent years, we have sustained significant operating losses. We have been unable to generate sufficient cash flow from operations to meet our operating needs and, correspondingly, from time to time during the past several years, we have raised additional capital from external sources. We expect to continue to have to raise additional capital from external sources. These sources may include private or public financings through the issuance of debt, convertible debt or equity, or collaborative arrangements. 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. 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, or redemptions of Andrea's Series B and Series C Redeemable Convertible Preferred Stock. Given our current financial condition and market conditions, it may be difficult to attract additional financings on favorable terms, or at all, as compared to prior periods. We have revised our business strategies to reduce our expenses and capital expenditures, but we still do not generate sufficient cash flow from operations to meet our operating needs and we cannot assure you that we will be successful in obtaining financings or access to additional sources of funding in amounts necessary to continue our operations. Failure to maintain sufficient access to funding may also result in our delisting from the American Stock Exchange.

We face the risk that Andrea could be required to redeem the 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.

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 investor's Preferred Shares at a redemption

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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. If we are forced to redeem the Series B Preferred Stock, we would not have sufficient cash to satisfy the cost of redemption.

We face the risk that Andrea could be required to redeem the Series C Redeemable Convertible Preferred Stock.

On October 10, 2000, Andrea issued and sold in a private placement \$7,500,000 of Series C Redeemable Convertible Preferred Stock (the "Series C Preferred Stock"). The Series C Preferred Stock is convertible or redeemable at maturity by Andrea, based upon certain circumstances at that time, and is redeemable by the holder upon certain events, including the announcement of a major transaction, as defined in the Certificate of Amendment, or upon certain other triggering events. In the first quarter of 2002, a triggering event occurred and we obtained a waiver from the Series C Preferred Stock holders of their redemption right. A final agreement regarding the waiver arrangement was reached on March 28, 2002. The waiver related to the existing triggering event, as well as certain possible future triggering events, however, the waiver will be null and void upon the earlier of April 7, 2007, the first date on which

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Andrea fails to comply in any material respect with the terms of the waiver and related documents, and the first date on which Andrea is insolvent.

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

Given that the waiver granted by the Series C Preferred Stock holder does not cover all triggering events that could require the redemption of the Series C Preferred Stock, and that the waiver will be null and void in the event Andrea fails to comply in any material respect with the terms of the agreements relating to the waiver, among other things, there is a risk that the Series C Preferred Stock holder could declare a triggering event that would trigger the redemption rights. If such redemption rights are triggered and Andrea has insufficient funds to satisfy the redemption, which would be the

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case if a redemption occurred at this time, Andrea will be required to obtain a new waiver from the holder of the Series C Preferred Stock. If no such waiver can be obtained, Andrea's ability to continue its current operations will be materially adversely affected and if Andrea has insufficient funds to redeem the Series C Preferred Stock, it could result in Andrea's inability to meet its operating obligations and, consequently, delisting from the American Stock Exchange.

Shares Eligible For Future Sale May Have An Adverse Effect On Market Price; You May Experience Substantial Dilution.

Sales of a substantial number of shares of our common stock in the public market could have the effect of depressing the prevailing market price of our common stock. Of the 70,000,000 shares of common stock presently authorized, 20,043,864 were outstanding as of November 12, 2002. The number of shares outstanding does not include 6,632,375 shares of our common stock reserved for issuance upon exercise of outstanding awards granted under our 1991 Performance Equity Plan and 1998 Stock Plan and shares of our common stock reserved for further awards under the 1998 Stock Plan; nor does it include 14,410,947 shares of common stock reserved for issuance upon conversion of the Series B and Series C convertible preferred stock and exercise of related warrants.

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

As of November 12, 2002, we had 86 shares of Series B Preferred Stock and 749.19 shares of Series C Preferred Stock outstanding. Both the Series B Preferred Stock and the Series C 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.

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

The variable conversion price of the Series B Preferred Stock and the Series C 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 86 shares of Series B Preferred Stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 4% dividend is paid in cash:

Conversion Price	Number of Shares of Common Stock Issuable Upon Conversion (/1/)	Percentage of Outstanding Common Stock (/2/)
\$0.25	3,440,000	15%
\$0.30	2,866,667	13%
\$0.35	2,457,143	11%
\$0.40	2,150,000	10%

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\$0.45	1,911,111	9%
\$0.50	1,720,000	8%

- (1) The holder of Series B Preferred Stock is prohibited from converting its holdings of the Series B 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 20,043,864 shares of common stock outstanding as of November 12, 2002.

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 749.19 shares of Series C Preferred Stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 5% dividend amount is paid in cash:

Conversion Price	Number of Shares of Common Stock Issuable Upon Conversion (/1/)	Percentage of Outstanding Common Stock (/2/)
\$0.25	29,967,504	60%
\$0.26	28,814,907	59%
\$0.27	27,747,689	58%
\$0.28	26,756,700	57%
\$0.29	25,834,055	56%
\$0.30	24,972,920	55%

- (1) The holder of Series C Preferred Stock is prohibited from converting its holdings of the Series C Preferred Stock if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our common stock following such conversion. The numbers in this column do not reflect these limitations.
- (2) Based on 20,043,864 shares of common stock outstanding as of November 12, 2002.

The maximum conversion price of the Series C Preferred Stock is \$0.30.

The following table illustrates the varying amounts of shares of Common Stock that would be issuable upon conversion of all 86 outstanding shares of Series B Preferred stock and all 749.19 outstanding shares of Series C 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 Outstanding Common Stock (/4/)
\$0.25	33,407,504	63%
\$0.26	32,122,600	62%
\$0.27	30,932,874	61%
\$0.28	29,828,128	60%

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\$0.29	28,799,572	59%
\$0.30	27,839,586	58%
\$0.35	27,430,063	58%
\$0.40	27,122,920	58%
\$0.45	26,884,031	57%
\$0.50	26,692,920	57%

- (1) The calculation assumes that the conversion price of the Series B and Series C Preferred Stock are the same at the assumed conversion prices of \$0.25, \$0.26, \$0.27, \$0.28, \$0.29 and \$0.30.
- (2) The calculation assumes that for any conversion of the Series B Preferred Stock when the prevailing market price is above \$ 0.30, the Series C Preferred Stock would still be converted at its maximum conversion price of \$ 0.30.
- (3) The holders of Series B and Series C Preferred Stock is prohibited from converting the Series C or Series B Preferred Stock, or from exercising the warrants issued in connection with the Series B 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 20,043,864 shares of common stock outstanding as of November 12, 2002.

The conversion rate at November 12, 2002 of the Series B Preferred Stock and the Series C Preferred Stock was \$0.28. If all of the outstanding shares of the Series B Preferred Stock and the Series C Preferred Stock were converted on November 12, 2002, we would have issued a total of 33,043,141 shares of common stock. If the market price of our common stock continues to decline, the conversion rates would increase, resulting in our issuing a greater number of shares upon conversion of the Series B Preferred Stock and the Series C Preferred Stock

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

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

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

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

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

Our business, results of operations and financial condition depend on successful commercialization of our Andrea DSP Microphone and Audio Software products and technologies. We introduced our first Andrea Digital

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Super Directional Array products in 1998 and we are initially targeting these and our other Andrea DSP Microphone and Audio Software products at the desktop computer market, the market for in-vehicle computing and the audio and video conferencing markets, among others. Since we began sales of our initial Andrea Anti-Noise Headset products in 1995, we have developed and introduced new products in this line. However, in the fourth quarter of 2001, we also restructured this business segment which resulted in a significant reduction in revenues. In addition, we recently developed and introduced a new aircraft intercom system aimed at increasing overall manufacturability as well as to enable future implementations of our Andrea DSP Microphone and Audio Software technologies. 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 Andrea DSP Microphone and Audio Software products and technologies or if market acceptance of these products and technologies occurs at a slow rate, then our business, results of operations and financial condition will be materially and adversely affected.

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

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

The markets in which we sell our Andrea Anti-Noise Headset, Andrea DSP Microphone and Audio Software 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

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processing products or technologies may not gain market acceptance.

In the markets for 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 and governmental standards and specifications that may require us to devote substantial time and expense to adapt our products and technologies. For example, our Aircraft Communications business segment is subject to the Federal Aviation Administration (FAA). 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.

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

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

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 experienced a 71% decline in sales of Aircraft Communication products in the 2002 Third Quarter when compared to the comparable prior year period. We are dependent on product sales to the U.S. Government. During the Third Quarter 2002, the U.S. Government accounted for 6% 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 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 (primarily in the Far East) using purchased components. Some specialized components for the Andrea Anti-Noise Headset, Aircraft Communications, and Andrea DSP Microphone products, such as microphones, digital signal processing boards and specialty switches, are available from a limited number of suppliers (in some cases foreign) and subject

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to long lead times. We may not be able to continue to obtain sufficient supplies of these more specialized components, particularly if the sales of our products increase substantially or market demand for these components otherwise increases.

If our 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 Headset 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

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other countries do not protect our proprietary rights to our technologies to the same extent as the laws of the United States.

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

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

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

We generate sales to regions outside the United States, particularly in Europe and areas in the Americas and Asia. For the three months and nine months ended September 30, 2002, sales to customers outside the United States accounted for approximately 10% and 15%, respectively of our net sales. International



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

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

Our performance is substantially dependent on the performance of our executive officers and key employees. The loss of the services of any of these executive officers or key employees could have a material adverse effect on our business, results of operations and financial condition. Our future success depends on our continuing ability to attract and retain highly qualified managers and technical personnel. As of the date of this filing, Andrea is in the process of negotiating contracts with each of Douglas J. Andrea, Chairman of the Board of Directors, Christopher P. Sauvigne, President and Chief Executive Officer, Joseph Marash, Chief Technology Officer and Richard A. Maue, Chief Financial Officer. Competition for qualified personnel is intense and we may not be able to attract, assimilate or retain qualified personnel in the future.

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### Results Of Operations

Quarter Ended September 30, 2002 Compared to the Quarter Ended September 30, 2001 and Nine Months Ended September 30, 2002 Compared to the Nine Months Ended September 30, 2001.

### Sales

Sales for the 2002 Third Quarter were \$1,370,029, a decrease of 53% from sales of \$2,937,199 for the 2001 Third Quarter. Sales for the 2002 First Nine Months were \$4,939,679, a decrease of 40% from the 2001 First Nine Months sales of \$8,170,767. The decrease in sales for the 2002 Third Quarter reflects an approximate 66% decrease in sales of Andrea Anti-Noise Headset Products to \$519,254, or 38% of total sales, an approximate 71% decrease of Aircraft Communications Product to \$347,116, or 25% of total sales, both partially offset by an approximate 155% increase in sales of our Andrea DSP Microphone and Audio Software Products, to \$503,659, or 37% of total sales. The decrease in sales for the 2002 First Nine Months reflects an approximate 56% decrease of Andrea Anti-Noise Headset Products to \$1,772,156, or 36% of total sales, an approximate 39% decrease of Aircraft Communications Product to \$2,171,450, or 44% of total sales, both partially offset by an approximate 66% increase in sales of our Andrea DSP Microphone and Audio Software Products, to \$996,073, or 20% of total sales.

The primary reason for the decreases in sales of Andrea Anti-Noise Headset Product is substantially due to our decision, during the fourth quarter 2001, to exit from an unprofitable, PC OEM/retail headset channel within Andrea's Anti-Noise Headset product segment. This customer channel included IBM, and for the Third Quarter 2002, sales to IBM and certain of IBM's affiliates, such sales representing contractual obligations which we accepted during 2001, accounted for approximately 2% of our total sales, or \$27,361. This reflects an approximate 98% decrease from \$1,164,703 for the Third Quarter 2001.

The decreases in our Aircraft Communication Product revenues is primarily a result of a decrease in U.S. Department of Defense funding which affected programs where Andrea's products are used, primarily during the 2002 Third Quarter. For the 2002 Third Quarter, sales of our Aircraft Communications Products to the U.S. Government accounted for approximately 6% of our total sales.

The increases in sales of Andrea DSP Microphone and Audio Software Products is primarily due to licensing revenue recognized during the Third Quarter 2002 associated with our agreements with Analog Devices.

### Cost of Sales

Cost of sales as a percentage of sales for the 2002 Third Quarter decreased to 49% from 72% in the 2001 Third Quarter. Cost of Sales as a percentage of sales for the 2002 First Nine Months decreased to 60% from 72% for the 2001 First Nine Months. These decreases primarily reflect the impact of the significant changes in the composition of our revenues as described under "Sales" above, in particular, the significant increase in high-margin license revenues associated with our agreements with Analog Devices (primarily attributable to the 2002 Third Quarter), coupled with

the elimination of sales of low-margin Andrea Anti-Noise Headset Products associated with our restructuring activity in the fourth quarter of 2001.

#### Research and Development

Research and development expenses for the 2002 Third Quarter increased 14% to \$884,772 from \$774,108 for the 2001 Third Quarter. Research and development expenses for the First Nine Months were \$2,677,128, an increase of 1% from the 2001 First Nine Months research and development expenses of \$2,654,392. The substantial amount of research and development is a reflection of our continuing efforts to develop and commercialize DSP microphone and audio technologies, coupled with, to a lesser extent, efforts in Aircraft Communication product technologies and Andrea Anti-Noise Headset Product technologies. For the 2002 Third Quarter, the Andrea DSP Microphone and Audio Software Technology efforts were \$727,378, or 82% of total research and development expenses, Aircraft Communications technology efforts were \$104,766 or 12% of total research and development expenses and Andrea Anti-Noise Headset Product efforts were \$52,628, or 6% of total research and development expenses. With respect to DSP Microphone and Audio Software Technologies, research efforts are primarily focused on the pursuit of commercializing a natural language-driven human/machine interface by developing optimal far-field microphone solutions for various voice-driven interfaces, incorporating Andrea's digital super directional array microphone technology ("DSDA") and certain other related technologies obtained through the acquisitio