ANDREA ELECTRONICS CORP
Form 10-Q
August 14, 2014
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 June 30, 2014

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to ____________

Commission file number 1-4324

ANDREA ELECTRONICS CORPORATION

(Exact name of registrant as specified in its charter)

New York	11-0482020
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)
65 Orville Drive, Bohemia, New York	11716
(Address of principal executive offices)	(Zip Code)
Registrant’s telephone number (including area code):	631-719-1800

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of August 8, 2014, there were 63,721,035 common shares outstanding.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2014 (unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash	$3,196,484	$1,000,422
Accounts receivable, net of allowance for doubtful accounts of $17,862 and $17,920, respectively	273,542	368,991
Inventories, net	804,408	820,586
Prepaid expenses and other current assets	103,100	75,858
Total current assets	4,377,534	2,265,857
Property and equipment, net	147,905	183,726
Intangible assets, net	347,440	326,109
Other assets, net	13,218	13,218
Total assets	$4,88,097	$2,788,910
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	$310,942	$341,436
Accrued Series C Preferred Stock Dividends	73,921	73,921
Short-term deferred revenue	10,326	12,141
Other current liabilities	237,584	161,681
Total current liabilities	632,773	589,179
Long-term deferred revenue	3,000,000	—
Long-term debt	401,837	—
Total liabilities	4,.034,610	589,179
Series B Redeemable Convertible Preferred Stock, $.01 par value; authorized: 1,000 shares; issued and outstanding: 0 shares	—	—
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, $.01 par value; authorized: 2,497,500 shares; none issued and outstanding	—	—

Series C Convertible Preferred Stock, net, $.01 par value; authorized: 1,500 shares; issued and outstanding: 44.2 shares; liquidation value: $442,314	1	1
Series D Convertible Preferred Stock, net, $.01 par value; authorized: 2,500,000 shares; issued and outstanding: 907,144 shares; liquidation value: $907,144	9,072	9,072
Common stock, $.01 par value; authorized: 200,000,000 shares; issued and outstanding: 63,721,035 shares	637,210	637,210
Additional paid-in capital	77,550,176	77,544,011
Accumulated deficit	(7,344,972)	(75,990,563)
Total shareholders' equity	851,487	2,199,731
Total liabilities and shareholders' equity	$4,886,097	$2,788,910

See Notes to Condensed Consolidated Financial Statements.

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ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Revenues				
Net product revenues	$381,594	$345,208	$805,755	$871,369
License revenues	217,627	626,413	412,471	775,832
Revenues	599,221	971,621	1,218,226	1,647,201
Cost of revenues	251,492	247,559	500,906	556,367
Gross margin	347,729	724,062	717,320	1,090,834
Research and development expenses	173,367	167,357	347,891	346,224
General, administrative and selling expenses	517,217	494,661	1,644,080	1,082,123
(Loss) income from operations	(342,855)	62,044	(1,274,651)	(337,513)
Interest income, net	1,362	1,743	1,857	3,872
(Loss) income before provision for income taxes	(341,493)	63,787	(1,272,794)	(333,641)
Provision for income taxes	43,031	—	81,615	—
Net (loss) income	$(384,524)	$63,787	$(1,354,409)	$(333,641)
Basic weighted average shares	63,721,035	63,721,035	63,721,035	63,721,035
Diluted weighted average shares	63,721,035	72,210,532	63,721,035	63,721,035
Basic and diluted net (loss) income per share	$(.01)	$.00	$(.02)	$(.01)

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS’ EQUITY

FOR THE SIX MONTHS ENDED JUNE 30, 2014

(UNAUDITED)

	Series C Convertible Preferred Stock Outstanding	Series C Convertible Preferred Stock	Series D Convertible Preferred Stock Outstanding	Series D Convertible Preferred Stock	Common Stock Shares Outstanding	Common Stock	Additional Paid-In Capital	Accumulated Deficit	Total Shareholders’ Equity
Balance, January 1, 2014	44.231432	$1	907,144	$9,072	63,721,035	$637,210	$77,544,011	$(75,990,563)	$2,199,731
Stock-based Compensation Expense related to Stock Option Grants	—	—	—	—	—	—	6,165	—	6,165
Net loss	—	—	—	—	—	—	—	(1,354,409)	(1,354,409)
Balance, June 30, 2014	44.231432	$1	907,144	$9,072	63,721,035	$637,210	$77,550,176	$(77,344,972)	$851,487

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the Six Months Ended	
	June 30, 2014	June 30, 2013
Cash flows from operating activities:		
Net loss	$(1,354,409)	$(333,641)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	56,301	280,108
Stock based compensation	6,165	11,810
Inventory reserve	6,892	(18,789)
Provision for income tax withholding	81,615	—
Change in:		
Accounts receivable	13,834	(399,169)
Inventories	9,286	(90,936)
Prepaid expenses, other current assets and other assets	(27,242)	(12,528)
Trade accounts payable	(30,494)	101,019
Other current liabilities	75,903	(1,199)
Long-term deferred revenue	3,000,000	—
Short-term deferred revenue	(1,815)	—
Net cash provided by (used in) operating activities	1,836,036	(463,325)
Cash flows used in investing activities:		
Purchases of patents and trademarks	(41,811)	(11,998)
Net cash used in investing activities	(41,811)	(11,998)
Cash flows provided by financing activities:		
Proceeds from long-term debt, net	401,837	—
Net cash provided by financing activities	401,837	—
Net increase (decrease) in cash	2,196,062	(475,323)
Cash, beginning of year	1,000,422	1,746,363
Cash, end of period	$3,196,484	$1,271,040
Supplemental disclosures of cash flow information:		
Cash paid for:		
Interest	$1,298	$—
Income Taxes	$86,888	$365

See Notes to Condensed Consolidated Financial Statements.

Note 1. Basis of Presentation

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

These unaudited condensed consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In addition, the December 31, 2013 balance sheet data was derived from the audited consolidated financial statements, but does not include all disclosures required by GAAP. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for any other interim period or for the fiscal year.

These unaudited condensed consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2013 included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, filed on March 25, 2014. The accounting policies used in preparing these unaudited condensed consolidated interim financial statements are consistent with those described in the December 31, 2013 audited consolidated financial statements.

Note 2. Summary of Significant Accounting Policies

Earnings Per Share - Basic earnings per share (“EPS”) is computed by dividing the net (loss) income by the weighted average number of common shares outstanding during the period. Diluted EPS adjusts basic EPS for the effects of convertible securities, stock options and other potentially dilutive financial instruments, only in the periods in which such effect is dilutive. Diluted EPS are based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method for the outstanding options, and the if-converted method for the outstanding convertible instruments. Under the treasury stock method, options are assumed to be exercised at the beginning of the period (or at the time of issuance, if later) and as if funds obtained thereby were used to purchase common stock at the average market price during the period. Under the if-converted method, outstanding convertible instruments are assumed to be converted into common stock at the beginning of the period (or at the time of issuance, if later). Securities that could potentially dilute basic EPS in the future that were not included in the computation of the diluted EPS because to do so would have been anti-dilutive for the periods presented, consist of the following:

	For the Three Months Ended	For the Six Months Ended

	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Total potential common shares as of:				
Options to purchase common stock (Note 7)	16,600,321	10,025,821	16,600,321	17,205,821
Series C Convertible Preferred Stock and related accrued dividends (Note 4)	2,023,658	—	2,023,658	2,023,658
Series D Convertible Preferred Stock (Note 5)	3,628,576	—	3,628,576	3,628,576
Total potential common shares	22,252,555	10,025,821	22,252,555	22,858,055

The following table sets forth the components used in the computation of basic and diluted EPS:

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Numerator:				
Net (loss) income	$(384,524)	$63,787	$(1,354,409)	$(333,641)
Denominator:				
Weighted average shares	63,721,035	63,721,035	63,721,035	63,721,035
Effect of dilutive securities:				
Series C Convertible Preferred Stock	—	2,023,658	—	—
Series D Convertible Preferred Stock	—	3,628,576	—	—
Options to purchase common stock	—	2,837,263	—	—
Denominator for diluted EPS-adjusted weighted average shares after assumed conversions	63,721,035	72,210,532	63,721,035	63,721,035

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Cash - Cash includes cash and highly liquid investments with original maturities of three months or less. At times during the periods ended June 30, 2014 and December 31, 2013, the Company had cash deposits in excess of the maximum amounts insured by the Federal Deposit Insurance Corporation insurance limits. At June 30, 2014 and December 31, 2013, the Company's cash was held at three financial institutions.

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

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Customer A	36%	60%	33%	42%
Customer B	15%	*	*	*

* Amounts are less than 10%

Customer A accounted for approximately 63% and 46% of total accounts receivable at June 30, 2014 and December 31, 2013, respectively.

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

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Supplier A	77%	81%	80%	86%
Supplier B	*	18%	*	14%
Supplier C	16%	*	17%	*

* Amounts are less than 10%

At June 30, 2014 and December 31, 2013, Supplier A accounted for approximately 35% and 43% of accounts payable, respectively.

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

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

	June 30, 2014	December 31, 2013
Raw materials	$34,557	$18,228
Finished goods	1,212,336	1,237,951
	1,246,893	1,256,179
Less: reserve for obsolescence	(442,485)	(435,593)
	$804,408	$820,586

Intangible and Long-Lived Assets - Andrea accounts for its long-lived assets in accordance with ASC 360 "Property, Plant and Equipment" for purposes of determining and measuring impairment of its long-lived assets (primarily intangible assets) other than goodwill. Andrea's policy is to periodically review the value assigned to its long-lived assets to determine if they have been permanently impaired by adverse conditions which may affect Andrea whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If Andrea identifies a permanent impairment such that the carrying amount of Andrea's long lived assets are not recoverable using the sum of an undiscounted cash flow projection (gross margin dollars from product revenues), a new cost basis for the impaired asset will be established. If required, an impairment charge is recorded based on an estimate of future discounted cash flows. This new cost basis will be net of any recorded impairment. At June 30, 2014 and June 30, 2013, Andrea concluded that Intangibles and long-lived assets were not required to be tested for recoverability.

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

During the three months ended March 31, 2013, it was determined that certain royalties related to a customer’s licensing agreement were not reported for 2012 and for the quarter ended March 31, 2013. The amount of unreported royalty revenue due to the Company was determined during the three months ended June 30, 2013. Since the Company was unable to estimate this amount at March 31, 2013, the Company did not record any revenue related to the unreported royalty revenue. During the three months ended June 30, 2013, the Company reported revenue of approximately $445,000, of which $295,000 and $150,000 consisted of royalties related to the licensing agreement from 2012 and for the quarter ended March 31, 2013, respectively.

Income Taxes - Andrea accounts for income taxes in accordance with ASC 740, “Income Taxes” (“ASC 740”). ASC 740 requires an asset and liability approach for financial accounting and reporting for income taxes and establishes for all entities a minimum threshold for financial statement recognition of the benefit of tax positions, and requires certain expanded disclosures. The provision for income taxes is based upon income or loss after adjustment for those permanent items that are not considered in the determination of taxable income. Deferred income taxes represent the tax effects of differences between the financial reporting and tax bases of the Company’s assets and liabilities at the enacted tax rates in effect for the years in which the differences are expected to reverse. The Company evaluates the recoverability of deferred tax assets and establishes a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of June 30, 2014 the Company has recorded a full valuation allowance. Andrea expects it will reduce its valuation allowance in future periods to the extent that it can demonstrate its ability to utilize the assets. Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In management’s opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary. Income tax expense consists of the tax payable for the period and the change during the period in deferred tax assets and liabilities. The Company has identified its federal tax return and its state tax return in New York as "major" tax jurisdictions. Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's condensed consolidated interim financial statements. The Company's evaluation was performed for tax years ended 2010 through 2013. The Company believes that its income tax positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position.

Stock-Based Compensation - At June 30, 2014, Andrea had two stock-based employee compensation plans, which are described more fully in Note 7. Andrea accounts for stock-based compensation in accordance with ASC 718, "Compensation – Stock Compensation" ("ASC 718"). ASC 718 establishes accounting for stock-based awards exchanged for employee services. Under the provisions of ASC 718, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the employee's requisite service period (generally the vesting period of the equity grant). The fair value of the Company's common stock options are estimated using the Black Scholes option-pricing model with the following assumptions: expected volatility, dividend rate, risk free interest rate and the expected life. The Company expenses stock-based compensation by using the straight-line method. In accordance with ASC 718, excess tax benefits realized from the exercise of stock-based awards are classified in cash flows from financing activities. The future realization of the reserved deferred tax assets related to these tax benefits associated with the exercise of stock options will result in a credit to additional paid in capital if the related tax deduction reduces taxes payable. The Company has elected the "with and without approach" regarding ordering of windfall tax benefits to determine whether the windfall tax benefit did reduce taxes payable in the current year. Under this approach, the windfall tax benefit would be recognized in additional paid-in-capital only if an incremental tax benefit is realized after considering all other benefits presently available.

Use of Estimates - The preparation of condensed consolidated interim financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the condensed consolidated interim financial statements and the reported amounts of revenues and expenses during the reporting period. Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. The most significant estimates, among other things, are used in accounting for allowances for bad debts, inventory valuation and obsolescence, product warranty, depreciation, deferred income taxes, expected realizable values for assets (primarily intangible assets), contingencies, revenue recognition as well as the recording and presentation of the Company's convertible preferred stock. Estimates and assumptions are periodically reviewed and the effects of any material revisions are reflected in the condensed consolidated interim financial statements in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

Reclassifications - Certain prior year amounts have been reclassified to conform to the current year presentation. The reclassifications did not have any effect on reported consolidated net loss for the periods presented.

Subsequent Events - The Company evaluates events that occurred after the balance sheet date but before the condensed consolidated interim financial statements are issued. Based upon the evaluation, except as noted in Note 6, the Company did not identify any recognized or non-recognized subsequent events that would have required adjustment or disclosure in the condensed consolidated interim financial statements.

Note 3. Revenue Sharing, Note Purchase Agreement, and Long-Term Debt

Revenue Sharing and Note Purchase Agreement

On February 14, 2014, ("the closing date") the Company entered into a Revenue Sharing and Note Purchase Agreement (the "Agreement") with AND34 Funding LLC ("AND34") (acting as the "Revenue Participants," the "Note Purchasers," and the "Collateral Agent"). Under the Agreement, the Company has granted AND34 a perpetual predetermined share in the rights of the Company's specified future revenues from patents currently owned by the Company (the "Patents") in exchange for $3,000,000, which is recorded as long-term deferred revenue. The deferred revenue will be recognized over the period in which the Company generates any future monetization revenues with AND34. In addition, the Company issued $200,000 of notes to the AND34 and has agreed to issue and sell to the AND34 additional notes ("Notes") up to $4,000,000 during the four years after the closing date (which may extend to a fifth year by mutual agreement), or such greater amount as the AND34 may agree in their sole discretion. The proceeds of the Notes will be used to pay certain initial expenses related to the agreement, and going forward will be used for future expenses of the Company incurred in pursuing patent monetization. The rights to the Company's revenues from the Patents and the Notes are secured by the Patents. An additional $200,000 of notes payable was issued during the three months ended June 30, 2014.

Any Monetization Revenues (as defined in the Agreement) received from the Patents will first be applied 100% to the payment of accrued and unpaid interest on, and then to repay outstanding principal of, the Notes. After the Notes are paid in full, the Monetization Revenues received from the Patents will be allocated amongst the Revenue Participants and the Company in accordance with certain predetermined percentages (based on aggregate amounts received by the Revenue Participants) ranging from 100% to the Revenue Participants (such percentage to be allocated to the Revenue Participants until they have received $3,000,000) to ultimately 20% to the Revenue Participants. Monetization

Revenues is defined in the Agreement to include, but is not limited to, amounts that the Company receives from third parties with respect to the Patents, which may include new license fees, settlement payments and judgments.

The Agreement contains many stipulations between the parties regarding the handling of various matters related to the Company's Patents and the monetization of the Patents. In particular, the Company must use its best efforts to diligently pursue the monetization of the Patents pursuant to a business plan agreed to by the Company, the Note Purchasers and the Revenue Participants (the "Business Plan"). In addition, the Company has agreed to limits on its ability to incur indebtedness, create any liens on its Patents and dispose of its Patents.

Following an Event of Default, which is defined in the Agreement to include a failure to perform or observe any of the covenants or agreements set forth in the Agreement, including a failure to comply with the Business Plan, the Note Purchasers and Revenue Participants may proceed to protect and enforce their rights by suit or other appropriate proceeding, either for specific performance or the exercise of any power granted under the Agreement or ancillary documents including the Notes. In addition, upon a change in control of the Company or an Event of Default based on the Business Plan, the Note Purchasers and Revenue Participants and the Collateral Agent may either exercise the patent license granted to the Collateral Agent, direct the Company to assign the patents to a special purpose entity controlled by the Note Purchasers and Revenue Participants or perfect the security interest in the Patents, provided that in the case of any assignment of the Patents, the Company will have a non-revocable, perpetual sub-licensable right and license back to use the Patents for the sale of proprietary products and other licenses consistent with the Agreement.

Long-term debt

Long-term debt consists of the following:

	June 30, 2014	December 31, 2013
Note Payable	$400,000	$—
PIK interest	1,837	—
Total long-term debt	401,837	—
Less: current maturities of long-term debt	—	—
Long-term debt, net of current maturities	$401,837	$—

The unpaid principal amount of the Notes (including any PIK Interest) will have an interest rate equal to LIBOR plus 2% per annum, (3% at June 30, 2014); provided that upon and during the continuance of an Event of Default (as set forth in the Agreement), the interest rate will increase an additional 2% per annum. Interest may be paid in cash at the option of the Company and otherwise shall be paid by increasing the principal amount of the Notes by the amount of such interest ("PIK Interest"). The principal balance of the Notes and all unpaid interest thereon will be due on June 30, 2019. The Company may prepay the Notes from time to time in whole or in part, without penalty or premium.

Note 4. Series C Convertible Preferred Stock

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

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

As of June 30, 2014, there were 44.231432 shares of Series C Preferred Stock outstanding, which were convertible into 2,023,658 shares of Common Stock and remaining accrued dividends of $73,921.

Note 5. Series D Convertible Preferred Stock

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

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

The shares of Series D Preferred Stock are also subject to antidilution provisions, which are triggered in the event of certain stock splits, recapitalizations, or other dilutive transactions. In addition, issuances of common stock at a price below the conversion price then in effect (currently $0.25), or the issuance of warrants, options, rights, or convertible securities which have an exercise price or conversion price less than that conversion price, other than for certain previously outstanding securities and certain “excluded securities” (as defined in the certificate of amendment), require the adjustment of the conversion price to that lower price at which shares of common stock have been issued or may be acquired. In the event that Andrea issues securities in the future which have a conversion price or exercise price which varies with the market price and the terms of such variable price are more favorable than the conversion price in the Series D Preferred Stock, the purchasers may elect to substitute the more favorable variable price when making conversions of the Series D Preferred Stock. In addition, the Company is required to use its best efforts to secure the inclusion for quotation on the Over the Counter Bulletin Board for the common stock issuable under the Series D Preferred Stock and to arrange for at least two market makers to register with the Financial Industry Regulatory Authority. In the event that the holder of the Series D Preferred Stock and related warrants is unable to convert these securities into Andrea Common Stock, the Company shall pay to each such holder a Registration Delay Payment. This payment is to be paid in cash and is equal to the product of (i) the stated value of such Preferred Shares multiplied by (ii) the product of (1) .0005 multiplied by (2) the number of days that sales cannot be made pursuant to the Registration Statement (excluding any days during that may be considered grace periods as defined by the Registration Rights Agreement).

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

As of June 30, 2014, there were 907,144 shares of Series D Preferred Stock outstanding which were convertible into 3,628,576 shares of Common Stock.

Note 6. Commitments And Contingencies

<u>Leases</u>

Andrea leases its corporate headquarters located in Bohemia, New York. The lease from an unrelated party, which currently expires in April 2015, is for approximately 11,000 square feet and houses Andrea’s warehousing, sales and executive offices. Rent expense under this operating lease was $24,930 and $49,370 for the three and six-month periods ended June 30, 2014, respectively. Rent expense under this operating lease was $24,203 and $47,932 for the three and six-month periods ended June 30, 2013, respectively.

As of June 30, 2014, the minimum annual future lease payments, under this lease and all other noncancellable operating leases, are as follows:

2014 (July 1 – December 31)	$62,004
2015	49,167
2016	6,661
Total	$117.832

Employment Agreements

In July 2013, the Company entered into an employment agreement with Mr. Andrea. The effective date of the employment agreement is August 1, 2013 and expires July 31, 2014 and is subject to renewal as approved by the Compensation Committee of the Board of Directors. Pursuant to his employment agreement, Mr. Andrea will receive an annual base salary of $300,000 (which is $50,000 less than Mr. Andrea's salary for the period from August 1, 2011 to December 31, 2012). The employment agreement provides for quarterly bonuses equal to 25% of the Company's pre-bonus net after tax quarterly earnings in excess of $25,000 for a total quarterly bonus amount not to exceed $12,500; and annual bonuses equal to 10% of the Company's annual pre-bonus net after tax earnings in excess of $300,000. Adjustments to net after tax earnings shall be made to remove the impact of change in recognition of accumulated deferred tax asset value. All bonuses shall be payable as soon as the Company's cash flow permits. All bonus determinations or any additional bonus in excess of the above will be made in the sole discretion of the Compensation Committee. Mr. Andrea is also entitled to a change in control payment equal to two times his base salary, plus a prorated portion of Mr. Andrea's most recent annual and four quarterly bonuses paid immediately preceding the change in control, continuation of health and medical benefits for two years and immediate vesting of all stock options in the event of a change in control and subsequent termination of his employment within the later of the term of his employment agreement or 6 months following the change of control. In the event of his termination without cause or resignation with the Company's consent, Mr. Andrea is entitled to a severance payment equal to six months of his base salary and a continuation of health insurance coverage for Mr. Andrea, his spouse and his dependents for 12 months. At June 30, 2014, the future minimum cash commitments under this agreement aggregate $25,000. The Company plans to renew Mr. Andrea's employment agreement on substantially similar terms during the quarter ended September 30, 2014.

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

Legal Proceedings

In July 2014, in connection with the Agreement entered into, (as disclosed in Note 3), Andrea filed patent infringement lawsuits against Toshiba Corporation, Toshiba America, Inc., Toshiba America Information Systems, Lenovo Group Ltd., Lenovo Holding Company, Inc., Lenovo (United States) Inc., Acer Inc., and Acer America Corporation, in the United States District Court for the Eastern District of New York. Andrea is asserting infringement related to U.S. Patent numbers 6,483,923 ("System and Method for Adaptive Interference Cancelling"), 5,825,898 ("System and Method for Adaptive Interference Cancelling"), 6,363,345 ("System, Method and Apparatus for Cancelling Noise"), and 6,049,607 ("Interference Canceling Method and Apparatus"). According to the complaints, the named defendants offer in the United States products, such as desktop and laptop computers, that use the patent protected audio enhancement technology. The suits seek, among other things, monetary damages and injunctive relief prohibiting the defendants from using the patented technology in their products.

In May 2014, John Hallum and Janet Hallum, filed a law suit in the County Court of Dallas County, Texas, against Alcatel-Lucent USA, Inc. and over 40 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the their contraction of asbestos-related mesothelioma and other asbestos-related pathologies. The Company retained legal counsel and a dismissal via a non-suit was obtained on July 11, 2014.

In May 2013, Wayne F. Jones and Roberta Jones, filed a law suit in the Superior Court of Providence County, Rhode Island, against 84 Lumber Company and over 120 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the their contraction of asbestos-related mesothelioma and other asbestos-related pathologies. The Company retained legal counsel and filed a response to the compliant. In February 2014, Andrea sought and was granted a Motion for Summary Judgment and Motion for Entry of Final Judgment pursuant to Rule 54(b).

In December 2010, Audrey Edwards, Executrix of the Estate of Leon Leroy Edwards, filed a law suit in the Superior Court of Providence County, Rhode Island, against 3M Company and over 90 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the death of Leon Leroy Edwards. The Company received service of process in April 2011. The Company has retained legal counsel and has filed a response to the compliant. The Company believes the lawsuit is without merit and intends to file a Motion for Summary Judgment to that affect. Accordingly, the Company does not believe the lawsuit will have a material adverse effect on the Company's financial position or results of operations.

Note 7. Stock Plans and Stock Based Compensation

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

In October 2006, the Board adopted the Andrea Electronics Corporation 2006 Equity Compensation Plan ("2006 Plan"), which was subsequently approved by the shareholders. The 2006 Plan, as amended, authorizes the granting of awards, the exercise of which would allow up to an aggregate of 18,000,000 shares of Andrea's Common Stock to be acquired by the holders of those awards. The awards can take the form of stock options, stock appreciation rights, restricted stock or other stock-based awards. Awards may be granted to key employees, officers, directors and consultants. At June 30, 2014, there were 4,461,936 shares available for further issuance under the 2006 Plan.

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

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

There were no options granted during the three and six months ended June 30, 2014 and 2013.

Option activity during 2014 is summarized as follows:

	Options Outstanding				Options Exercisable			
	Options Outstanding	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Life	Options Exercisable	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Life
At January 1, 2014	17,225,321	$ 0.08	$ 0.08	4.03 years	17,108,654	$ 0.08	$ 0.08	3.99 years
Cancelled/Expired	(625,000)	$ 0.12	$ 0.12					
At June 30, 2014	16,600,321	$ 0.08	$ 0.08	3.59 years	16,483,654	$ 0.08	$ 0.08	3.55 years

Based on the June 30, 2014 fair market value of the Company's common stock of $0.08, the aggregate intrinsic value for the 16,600,321 options outstanding and 16,483,654 shares exercisable is $265,250.

Total compensation expense recognized related to stock option awards was $2,583 and $5,937 for the three months ended June 30, 2014 and 2013, respectively. In the accompanying condensed consolidated statements of operations for the three months ended June 30, 2014, $2,583 of expense is included in general, administrative and selling expenses. In the accompanying condensed consolidated statements of operations for the three months ending June 30, 2013, $5,094 of expense is included in general, administrative and selling expenses, $675 is included in research and development expenses and $168 is included in cost of revenues. Total compensation expense recognized related to all stock option awards was $6,165 and $11,810 for the six months ending June 30, 2014 and 2013, respectively. In the accompanying condensed consolidated statements of operations for the six months ending June 30, 2014, $6,165 of expense is included in general, administrative and selling expenses. In the accompanying condensed consolidated statements of operations for the six months ending June 30, 2013, $10,188 of expense is included in general, administrative and selling expenses, $1,350 is included in research and development expenses and $272 is included in cost of revenues.

As of June 30, 2014, there was $5,586 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the 2006 Plans. This unrecognized compensation cost is expected to be recognized during 2014 and 2015.

Note 8. Segment Information

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

The following represents selected condensed consolidated interim financial information for Andrea's segments for the three-month periods ending June 30, 2014 and 2013.

2014 Three Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	2014 Three Month Total
Net revenues from external customers	$36,022	$345,572	$381,594
License revenues	217,627	—	217,627
Loss from operations	(106,712)	(236,143)	(342,855)
Depreciation and amortization	13,896	14,279	28,175
Purchases of patents and trademarks	17,897	—	17,897
Assets	3,642,852	1,243,245	4,886,097
Property and equipment and intangibles	348,711	146,634	495,345

2013 Three Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	2013 Three Month Total
Net revenues from external customers	$33,358	$311,850	$345,208
License revenues	626,413	—	626,413
Income (loss) from operations	347,773	(285,729)	62,044
Depreciation and amortization	120,034	19,762	139,796
Purchases of patents and trademarks	13,018	273	13,291

December 31, 2013 Year End Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	2013 Year End Total
Assets	$1,277,040	$1,511,870	$2,788,910
Property and equipment and intangibles	334,645	175,190	509,835

The following represents selected condensed consolidated interim financial information for Andrea's segments for the six-month periods ending June 30, 2014 and 2013:

2014 Six Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	2014 Six Month Total
Net revenues from external customers	$53,719	$752,036	$805,755
License revenues	412,471	—	412,471
Loss from operations	(748,281)	(526,370)	(1,274,651)
Depreciation and amortization	27,745	28,556	56,301
Purchases of patents and trademarks	41,811	—	41,811

2013 Six Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	` 2013 Six Month Total
Net revenues from external customers	$76,753	$794,616	$871,369
License revenues	775,832	—	775,832
Income (loss) from operations	195,420	(532,933)	(337,513)
Depreciation and amortization	240,081	40,027	280,108
Purchases of patents and trademarks	9,001	2,997	11,998

Management assesses non-operating income statement data on a consolidated basis only. International revenues are based on the country in which the end-user is located. For the three-month periods ending June 30, 2014 and 2013, net revenues by geographic area are as follows:

Geographic Data	June 30, 2014	June 30, 2013
Net revenues:		
United States	$339,697	$330,155
Foreign(1)	259,524	641,466
	$599,221	$971,621

(1) Net revenue from the People's Republic of China and Singapore represented 36% and 60% of total net revenues for the three months ending June 30, 2014 and June 30, 2013, respectively.

For the six-month periods ending June 30, 2014 and 2013, net revenues by geographic area are as follows:

Geographic Data	June 30, 2014	June 30, 2013
Net revenues:		
United States	$662,886	$800,885
Foreign(1)	555,340	846,316
	$1,218,226	$1,647,201

(1) Net revenue from the People's Republic of China and Singapore represented 33% and 42% of total net revenues for the six months ending June 30, 2014 and June 30, 2013, respectively.

As of June 30, 2014 and December 31, 2013, accounts receivable by geographic area is as follows:

Geographic Data	June 30, 2014	December 31, 2013
Accounts receivable:		
United States	$86,390	$141,621
Foreign	187,152	227,370
	$273,542	$368,991

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

Overview

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

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

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

Our Critical Accounting Policies

Our unaudited condensed consolidated interim financial statements and the notes to our unaudited condensed consolidated interim financial statements contain information that is pertinent to management's discussion and analysis. The preparation of unaudited condensed consolidated interim financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. On a continual basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results may vary from these estimates and assumptions under different and/or future circumstances. Our significant accounting policies are described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013. A discussion of our critical accounting policies and estimates are included in Management’s Discussion and Analysis or Plan of Operation in our Annual Report on Form 10-K for the year ended December 31, 2013. Management has discussed the development and selection of these policies with the Audit Committee of the Company’s Board of Directors, and the Audit Committee of the Board of Directors has reviewed the Company’s disclosures of these policies. There have been no material changes to the critical accounting policies or estimates reported in the Management’s Discussion and Analysis section of the Annual Report on Form 10-K for the year ended December 31, 2013.

Cautionary Statement Regarding Forward-Looking Statements

This report contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of the Company. These forward-looking statements are generally identified by use of the words “believe”, “expect”, “intend”, “anticipate”, “estimate”, “project” or similar expressions. The Company’s ability to predic results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in economic, competitive, governmental, technological and other factors that may affect our business and prospects. Additional factors are discussed below under Part II, *“Item 1A – Risk Factors”* and in Part I, *“Item 1A – Risk Factors”* in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

Results Of Operations

Three and Six Months ended June 30, 2014 compared to Three and Six Months ended June 30, 2013

Net Revenues

	For the Three Months Ended June 30,		%	For the Six Months Ended June 30,		%	
	2014	2013	Change	2014	2013	Change	
Andrea Anti-Noise Products net revenues							
Sales of products to OEM customers for use with educational software	$96,522	$7,082	1,263	$101,081	$28,375	256	(a)
All other Andrea Anti-Noise net product revenues	249,050	304,768	(18)	650,955	766,241	(15)	(b)
Total Andrea Anti-Noise Products net revenues	$345,572	$311,850	11	$752,036	$794,616	(5)	
Andrea DSP Microphone and Audio Software Products net revenues							
Sales of automotive array microphone products	22,622	3,996	466	31,621	3,996	691	(c)
All other Andrea DSP Microphone and Audio product net revenues	13,400	29,362	(54)	22,098	72,757	(70)	(d)
License revenues	217,627	626,413	(65)	412,471	775,832	(47)	(e)
Total Andrea DSP Microphone and Audio Software Products net revenues	253,649	659,771	(62)	466,190	852,585	(45)	
Total Revenues	$599,221	$971,621	(38)	$1,218,226	$1,647,201	(26)	

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(a) The increases of approximately \$89,000 and \$73,000 for the three and six months ended June 30, 2014, respectively, as compared to the three and six months ended June 30, 2013, represent increased product sales to our educational customers for use with their distance learning products. We believe that these changes in product sales relate to the timing of the customers' demand for our products.

(b) The decreases of approximately \$56,000 and \$115,000 for the three and six months ended June 30, 2014, respectively, as compared to the three and six months ended June 30, 2013, in all other Andrea Anti-noise net product revenues is primarily related to decreased demand from our distance learning customers as well as our distributor and reseller customers.

(c) The increases of approximately \$19,000 and \$28,000 for the three and six months ended June 30, 2014, respectively, as compared to the three and six months ended June 30, 2013, in sales of automotive array microphone products is primarily the result of increased product sales to integrators of public safety vehicle solutions.

(d) The decreases of approximately \$16,000 and \$51,000 for the three and six months ended June 30, 2014, respectively, as compared to the three and six months ended June 30, 2013, in all other Andrea DSP Microphone and Audio Software net product revenues is related to decreased demand from our OEM customers.

(e) The decreases of approximately \$409,000 and \$363,000 for the three and six months ended June 30, 2014, respectively, as compared to the three and six months ended June 30, 2013, is the result of an decrease in sales of PC models which feature our technology coupled with approximately \$295,000 and \$150,000 of certain royalties related to a customer's licensing agreement that were not reported for 2012 and the quarter ended March 31, 2013, respectively. These revenues were recorded in the six months ended June 30, 2013.

Cost of Revenues

Cost of revenues as a percentage of net revenues for the three months ended June 30, 2014 increased to 42% from 25% for the three months ended June 30, 2013. This increase is because of the decrease of licensing revenue for the three months ended June 30, 2014, as compared to 2013. The cost of revenues as a percentage of net revenues for the three months ended June 30, 2014 for Andrea Anti-Noise Products was 66% compared to 72% for the three months ended June 30, 2013. The cost of revenues as a percentage of net revenues for the three months ended June 30, 2014 for Andrea DSP Microphone and Audio Software Products was 9% compared to 4% for the three months ended June 30, 2013. Cost of revenues as a percentage of net revenues for the six months ended June 30, 2014 increased to 41% from 34% for the six months ended June 30, 2013. This increase is because of the decrease of licensing revenue for the three months ended June 30, 2014, as compared to 2013. The cost of revenues as a percentage of net revenues for the six months ended June 30, 2014 for Andrea Anti-Noise Products was 60% compared to 64% for the six months ended June 30, 2013. The cost of revenues as a percentage of net revenues for the six months ended June 30, 2014 for Andrea DSP Microphone and Audio Software Products was 10% compared to 6% for the six months ended June 30, 2013. The decreases for the Andrea Anti-Noise Products revenues for the three and six month periods was attributable to the mix of different product revenues within the segment which reflected sales of higher margin products combined with an increase in revenues in this segment for three months ended June 30, 2014 as compared to 2013. The increases in cost of sales as a percentage of sales for Andrea DSP Microphone and Audio Software products segment for the three and six month periods relate to decreased licensing revenues.

Research and Development Expenses

Research and development expenses for the three months ended June 30, 2014 increased 4% to $173,367 from $167,357 for the three months ended June 30, 2013. For the three months ended June 30, 2014, the increase in research and development expenses reflects a 6% increase in our Andrea DSP Microphone and Audio Software Technology efforts to $103,201, or 60% of total research and development expenses and a 1% increase in our Andrea Anti-Noise Headset Product efforts to $70,166, or 40% of total research and development expenses. Research and development expenses for the six months ended June 30, 2014 increased less than 1% to $347,891 from $346,224 for the six months ended June 30, 2013. For the six months ended June 30, 2014, the increase in research and development expenses reflects a 1% increase in our Andrea DSP Microphone and Audio Software Technology efforts to $208,792, or 60% of total research and development expenses while our Andrea Anti-Noise Headset Product efforts remained relatively flat at $139,099, or 40% of total research and development expenses.

General, Administrative and Selling Expenses

General, administrative and selling expenses increased 5% to $517,217 for the three months ended June 30, 2014 from $494,661 for the three months ended June 30, 2013. This increase of approximately $23,000 is primarily related to an increase in monetization expenses of approximately $189,000 offset in part by decreases in expenses related to amortization, compensation and promotion and marketing. For the three months ended June 30, 2014, the expenses reflect a 24% increase in our Andrea DSP Microphone and Audio Software Technology efforts to $235,200 or 45% of total general, administrative and selling expenses and a 7% decrease in our Andrea Anti-Noise Headset Product efforts to $282,017, or 55% of total general, administrative and selling expenses. General, administrative and selling expenses increased 52% to, $1,644,080 for the six months ended June 30, 2014 from $1,082,123 for the six months ended June 30, 2013. For the six months ended June 30, 2014, the expenses reflect a 139% increase in our Andrea DSP

Microphone and Audio Software Technology efforts to $958,082, or 58% of total general, administrative and selling expenses and less than a 1% increase in our Andrea Anti-Noise Headset Product efforts to $685,998, or 42% of total general, administrative and selling expenses. This increase of approximately $562,000 is primarily related to costs associated with consummating the Revenue Sharing and Note Purchase Agreement and an increase in monetization expenses of approximately $526,000.

Interest Income, net

Interest income, net for the three months ended June 30, 2014 was $1,362 compared to $1,743 for the three months ended June 30, 2013. Interest income, net for the six months ended June 30, 2014 was $1,857 compared to $3,872 for the six months ended June 30, 2013. The decrease in interest income, net is due to the interest expense related to the Revenue Sharing and Note Purchase Agreement.

Provision for Income Taxes

The provision for income taxes for the three and six months ended June 30, 2014 was $43,031 and $81,615, respectively. There was no benefit or provision for income taxes for the three and six months ended June 30, 2013. The provision for income taxes for the three and six months ended June 30, 2014 are a result of licensing revenues that are subject to withholding of income tax as mandated by the foreign jurisdiction in which the revenues are earned. Although the provisions could be offset by future tax benefits since it is unlikely that Company will be able to use these types of foreign tax credits as well as that the Company records a full valuation against deferred tax assets until such benefits will be utilized, the provisions will not be reduced by such tax benefits. Additionally, the Company expects to have taxable income as a result of the long-term deferred revenue created by the Revenue Sharing and Note Purchase Agreement. The Company will offset the taxable income by utilization of their net operating loss carry forwards and reduce its valuation allowance by approximately $300,000. This reduction will be offset by the same reduction of the deferred tax asset resulting in no benefit or provision for the three or six months ended June 30, 2014 relating to taxable income from the long-term deferred revenue.

Net (Loss) Income

Net loss for the three months ended June 30, 2014 was $384,524 compared to net income of $63,787 for the three months ended June 30, 2013. Net loss for the six months ended June 30, 2014 was $1,354,409 compared to net loss of $333,641 for the six months ended June 30, 2013. The net loss for the three and six months ended June 30, 2014 and 2013 principally reflects the factors described above.

Off-Balance Sheet Arrangements

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

Liquidity And Capital Resources

At June 30, 2014, we had cash of $3,196,484 compared with $1,000,422 at December 31, 2013. The increase in our cash balance at June 30, 2014 was primarily a result of the $3,000,000 received in connection with the Revenue Sharing and Note Purchase Agreement offset in part by our cash used in operations.

Our working capital balance at June 30, 2014 was $3,744,761 compared to working capital of $1,676,678 at December 31, 2013. The increase in working capital reflects an increase in total current assets of $2,111,677, partially offset by an increase in total current liabilities of $43,594. The increase in total current assets reflects an increase in cash of $2,196,062, a decrease in accounts receivable of $95,449, a decrease in inventories of $16,178 and an increase in prepaid expenses and other current assets of $27,242. The increase in total current liabilities of $43,594 reflects a decrease in trade accounts payable of $30,494, a decrease in short-term deferred revenue of $1,815 and an increase of $75,903 in other current liabilities.

The increase in cash of $2,196,062 reflects $1,836,036 of net cash provided by operating activities, $41,811 of cash used in investing activities and $401,837 of cash provided by financing activities.

The cash provided by operating activities of $1,836,036, excluding non-cash charges for the six months ended June 30, 2014, was attributable to a $13,834 decrease in accounts receivable, a $9,286 decrease in inventories, a $27,242 increase in prepaid expenses, other current assets and other assets, a $30,494 decrease in trade accounts payable, a $75,903 increase in other current liabilities, a $1,815 decrease in short-term deferred revenue, and a 3,000,000 increase in long-term deferred revenue. The changes in accounts receivable, inventories, prepaid expenses, other current assets and other assets, trade accounts payable, other current liabilities and short-term deferred revenue primarily reflect differences in the timing related to both the payments for and the acquisition of inventory as well as for other services in connection with ongoing efforts related to Andrea's various product lines. The increase in cash and long-term deferred revenue is primarily a result of the Revenue Sharing and Note Purchase Agreement.

We plan to improve our cash flows in 2014 by aggressively pursuing monetization of our patents related to our Andrea DSP Microphone Audio Software, increasing the sales of our Andrea Anti-Noise Products through the introduction of new products as well as the increased efforts we are putting into our sales and marketing efforts. In February 2014, we entered into a Revenue Sharing and Note Purchase Agreement. Under this Agreement, we received $3,000,000 in exchange for a perpetual predetermined share in the rights of our specified future revenues from patents owned by Andrea. Additionally, we borrowed $400,000 of notes and have access to borrow up to an additional $3,800,000 during the next four years. The proceeds of the notes will be used to pay patent monetization expenses. As a result of the past few years of performance and the execution of this Agreement, we believe that we have sufficient liquidity to continue our operations at least through June 2015. As of August 8, 2014, Andrea had approximately $2,900,000 of cash deposits. We cannot assure that demand will continue for any of our products, including future products related to our Andrea DSP Microphone and Audio Software technologies, or, that if such demand does exist, that we will be able to obtain the necessary working capital to increase production and provide marketing resources to meet such demand on favorable terms, or at all.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

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

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

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

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In July 2014, Andrea filed patent infringement lawsuits against Toshiba Corporation, Toshiba America, Inc., Toshiba America Information Systems, Lenovo Group Ltd., Lenovo Holding Company, Inc., Lenovo (United States) Inc., Acer Inc., and Acer America Corporation, in the United States District Court for the Eastern District of New York. Andrea is asserting infringement related to U.S. Patent numbers 6,483,923 (“System and Method for Adaptive Interference Cancelling”), 5,825,898 (“System and Method for Adaptive Interference Cancelling”), 6,363,345 (“System, Method and Apparatus for Cancelling Noise”), and 6,049,607 (“Interference Canceling Method and Apparatus”). According to the complaints, the named defendants offer in the United States products, such as desktop and laptop computers, that use the patent protected audio enhancement technology. The suits seek, among other things, monetary damages and injunctive relief prohibiting the defendants from using the patented technology in their products.

In May 2014, John Hallum and Janet Hallum, , filed a law suit in the County Court of Dallas County, Texas, against Alcatel-Lucent USA, Inc. and over 40 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the their contraction of asbestos-related mesothelioma and other asbestos-related pathologies. The Company retained legal counsel and a dismissal via a non-suit was obtained on July 11, 2014.

In May 2013, Wayne F. Jones and Roberta Jones, filed a law suit in the Superior Court of Providence County, Rhode Island, against 84 Lumber Company and over 120 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the their contraction of asbestos-related mesothelioma and other asbestos-related pathologies. The Company retained legal counsel and filed a response to the compliant. In February 2014, Andrea sought and was granted a Motion for Summary Judgment and Motion for Entry of Final Judgment pursuant to Rule 54(b).

In December 2010, Audrey Edwards, Executrix of the Estate of Leon Leroy Edwards, filed a law suit in the Superior Court of Providence County, Rhode Island, against 3M Company and over 90 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the death of Leon Leroy Edwards. The Company received service of process in April 2011. The Company has retained legal counsel and has filed a response to the compliant. The Company believes the lawsuit is without merit and intends to file a Motion for Summary Judgment to that affect. Accordingly, the Company does not believe the lawsuit will have a material adverse effect on the Company's financial position or results of operations.

ITEM 1A. RISK FACTORS

Risk Factors

Andrea is a party to a Revenue Sharing and Note Purchase Agreement under which a perpetual predetermined share of its future Monetization Revenues will be allocated to AND34 and under which a default, including the inability to comply with a business plan, could cause a material adverse effect on its financial position.

Under the Revenue Sharing and Note Purchase Agreement that we entered into with AND34, Monetization Revenues will first be applied 100% to the payment of accrued and unpaid interest on, and then to repay outstanding principal of notes. After the notes are paid in full, Monetization Revenues received will be allocated to AND34 and the Company in accordance with certain predetermined percentages ranging from 100% until AND34 has received $3,000,000 to ultimately 20%. The Agreement contains many stipulations between the parties regarding the handling of various matters related to our patents and the monetization of our patents. In particular, we must use our best efforts to diligently pursue the monetization of the patents pursuant to a business plan agreed to by the Company and AND34 (the "Business Plan"). In addition, the Company has agreed to limit its ability to incur indebtedness, create any liens on its patents and dispose of its patents. Following an Event of Default, which is defined in the Agreement to include a failure to perform or observe any of the covenants or stipulations set forth in the Agreement, including a failure to comply with the Business Plan, AND34 may proceed to protect and enforce their rights by suit or other appropriate proceeding, either for specific performance or the exercise of any power granted under the Agreement or ancillary documents including the notes. In addition, upon a change in control, as defined, of the Company or an Event of Default based on the Business Plan, AND34 may either exercise the patent license granted to them, direct the Company to assign the patents to a special purpose entity controlled by AND34 or perfect the security interest in the Patents, provided that in the case of any assignment of the patents, the Company will have a non-revocable, perpetual sub-licensable right and license back to use the patents for the sale of proprietary products and other licenses consistent with the Agreement.

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

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

- the volume of sales of our products under our collaborative marketing arrangements;
- the cost of development of our products;
- the mix of products we sell;
- the mix of distribution channels we use;
- the timing of our new product releases and those of our competitors;
- fluctuations in the computer and communications hardware and software marketplace; and
- general economic conditions.

We cannot assure that the level of revenues and gross profit, if any, that we achieve in any particular fiscal period will not be significantly lower than in other fiscal periods. Our net revenues for the three months ended June 30, 2014 were $599,221 compared to $971,621 for the three months ended June 30, 2013. Net loss for the three months ended June 30, 2014 was $384,525, or $0.01 loss per share on a basic and diluted basis compared to net income of $63,787 or $0.00 EPS on a basic and diluted basis for the three months ended June 30, 2013. Our net revenues for the six months ended June 30, 2014 were $1,218,226 compared to $1,647,201 for the six months ended June 30, 2013. Net loss for the six months ended June 30, 2014 was $1,354,409 or $0.02 loss per share on a basic and diluted basis, compared to net loss of $333,641, or $0.01 loss per share on a basic and diluted basis for the six months ended June 30, 2013. We continue to explore opportunities to grow sales in other business areas. We are also examining additional opportunities for cost reduction, production efficiencies and further diversification of our business.

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

Sales of a substantial number of shares of our common stock in the public market could have the effect of depressing the prevailing market price of our common stock. Of the 200,000,000 shares of common stock presently authorized, 63,721,035 were outstanding as of August 8, 2014. The number of shares outstanding does not include an aggregate of 26,464,491 shares of common stock that are issuable. This number of issuable common shares is equal to approximately 42% of the 63,721,035 outstanding shares. These issuable common shares are comprised of: a) 16,350,321 shares of our common stock reserved for issuance upon exercise of outstanding awards granted under our 1998 Stock Plan and 2006 Stock Plan; b) 4,461,936 shares reserved for future grants under our 2006 Stock Plan; c) 2,023,658 shares of common stock that are issuable upon conversion of the Series C Preferred Stock; and d) 3,628,576 shares of common stock issuable upon conversion of the Series D Preferred Stock.

In addition to the risk factors set forth above and the other information set forth in this report, you should carefully consider the factors discussed in Part I, *"Item 1A – Risk Factors"* in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, which could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

a) Exhibits

Exhibit 31.1 – Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

Exhibit 31.2 – Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

Exhibit 32 – Section 1350 Certifications

Exhibit 101.0 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets; (ii) the Condensed Consolidated Statements of Operations; (iii) the Condensed Consolidated Statement of Shareholders' Equity; (iv) the Condensed Consolidated Statements of Cash Flows and (v) the Notes to the Condensed Consolidated Interim Financial Statements.

SIGNATURES

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

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

Date: August 14, 2014

/s/ DOUGLAS J. ANDREA **Douglas J. Andrea**	Chairman of the Board, President, Chief Executive Officer and Corporate Secretary	August 14, 2014
/s/ CORISA L. GUIFFRE **Corisa L. Guiffre**	Vice President, Chief Financial Officer and Assistant Corporate Secretary	August 14, 2014

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