Qualstar Corporation and Subsidiaries

Quarterly Report for the Periods Ended September 30, 2020 and 2019

Qualstar Corporation
1 Jenner, Suite 200
Irvine, CA 92618
Phone: +1(805) 583-7744
www.qualstar.com

QUALSTAR CORPORATION

TABLE OF CONTENTS

PART I — FINANCIAL INFORMATION

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ITEM 1. Financial Statements

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)

	September 30, 2020	December 31, 2019
	(In thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 4,716	$ 3,863
Restricted cash	100	100
Accounts receivable, net	734	2,366
Inventories	2,975	2,540
Prepaid expenses and other current assets	238	211
Total current assets	8,763	9,080
Property and equipment, net	110	122
Right-of-use assets	487	676
Other assets	57	160
Total assets	$ 9,417	$ 10,038
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 889	$ 1,029
Accrued payroll and related liabilities	183	192
Deferred service revenue	623	702
Lease liabilities, current	230	252
PPP loan	258	–
Other accrued liabilities	184	368
Total current liabilities	2,367	2,543
Long-term liabilities:		
Lease liabilities, long term	283	453
Deferred service revenue, long-term	230	247
Other long-term liabilities	40	52
Total long-term liabilities	553	752
Total liabilities	2,920	3,295
Shareholders' equity:		
Preferred stock, no par value; 5,000,000 shares authorized; no shares issued	–	–
Common stock, no par value; 50,000,000 shares authorized, shares issued and outstanding 1,925,025 at September 30, 2020 and December 31, 2019	18,848	18,848
Accumulated deficit	(12,351)	(12,105)
Total shareholders' equity	6,497	6,743
Total liabilities and shareholders' equity	$ 9,417	$ 10,038

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
	(In thousands, except per share data)			
Net revenues	$ 1,855	$ 3,703	$ 5,817	$ 9,998
Cost of goods sold	1,076	2,749	3,603	7,319
Gross profit	779	954	2,214	2,679
Operating expenses:				
Engineering	163	122	342	473
Sales and marketing	393	368	1,007	982
General and administrative	412	427	1,120	1,078
Total operating expenses	968	917	2,469	2,533
Income (loss) from operations	(189)	37	(255)	146
Other income	–	12	9	33
Income (loss) before income taxes	(189)	49	(246)	179
Provision for income taxes	–	–	–	–
Net income (loss)	$ (189)	$ 49	$ (246)	$ 179
Earnings per share:				
Basic	$ (0.10)	$ 0.03	$ (0.13)	$ 0.09
Diluted	$ (0.10)	$ 0.03	$ (0.13)	$ 0.09
Weighted average common shares outstanding:				
Basic	1,925	1,922	1,925	1,967
Diluted	1,925	1,922	1,925	1,967

QUALSTAR CORPORATION
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(unaudited)

	Three Months Ended September 30, 2020			
	Common Stock		Accumulated	
	Shares	Amount	Deficit	Total
	(in thousands)			
Balances at June 30, 2020	1,925	$ 18,848	$ (12,162)	$ 6,686
Net loss	–	–	(189)	(189)
Balances at September 30, 2020	1,925	$ 18,848	$ (12,351)	$ 6,497

	Three Months Ended September 30, 2019			
	Common Stock		Accumulated	
	Shares	Amount	Deficit	Total
	(in thousands)			
Balances at June 30, 2019	1,937	$ 18,907	$ (11,968)	$ 6,939
Stock repurchase	(22)	(117)	–	(117)
Net income	–	–	49	49
Balances at September 30, 2019	1,915	$ 18,790	$ (11,919)	$ 6,871

	Nine Months Ended September 30, 2020			
	Common Stock		Accumulated	
	Shares	Amount	Deficit	Total
	(in thousands)			
Balances at December 31, 2019	1,925	$ 18,848	$ (12,105)	$ 6,743
Net loss	–	–	(246)	(246)
Balances at September 30, 2020	1,925	$ 18,848	$ (12,351)	$ 6,497

	Nine Months Ended September 30, 2019			
	Common Stock		Accumulated	
	Shares	Amount	Deficit	Total
	(in thousands)			
Balances at December 31, 2018	2,030	$ 19,426	$ (12,098)	$ 7,328
Stock repurchase	(115)	(636)	–	(636)
Net income	–	–	179	179
Balances at September 30, 2019	1,915	$ 18,790	$ (11,919)	$ 6,871

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine months Ended September 30, 2020	Nine months Ended September 30, 2019
	(In thousands)	
Cash flows from operating activities:		
Net income (loss)	$ (246)	$ 179
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	35	35
Loss on disposal of assets	–	30
Provision for inventory obsolescence, net	(14)	237
Amortization of right-of-use assets	189	269
Changes in operating assets and liabilities:		
Accounts receivable	1,632	(368)
Inventories	(422)	(68)
Prepaid expenses and other assets	76	(84)
Accounts payable	(141)	302
Accrued payroll and related liabilities	(8)	(8)
Deferred service revenue	(96)	65
Lease liabilities	(192)	(258)
Other liabilities	(195)	(120)
Net cash provided by operating activities	618	211
Cash flows from investing activities:		
Purchases of property and equipment	(23)	(85)
Net cash used in investing activities	(23)	(85)
Cash flows from financing activities:		
Purchase of common stock	–	(636)
Proceeds from PPP loan	258	–
Net cash provided by (used in) financing activities	258	(636)
Net increase (decrease) in cash, cash equivalents, and restricted cash	853	(510)
Cash, cash equivalents, and restricted cash at beginning of period	3,963	4,881
Cash, cash equivalents, and restricted cash at end of period	$ 4,816	$ 4,371
Reconciliation of cash, cash equivalents and restricted cash, end of period:		
Cash and cash equivalents, end of period	$ 4,716	$ 4,271
Restricted cash, end of period	100	100
Cash, cash equivalents and restricted cash, end of period	$ 4,816	$ 4,371
Supplemental disclosure of cash flow information:		
Income taxes paid	$ 4	$ 10
Supplemental non-cash investing and financing activities:		
Lease liabilities arising from obtaining right-of-use assets	$ –	$ 598

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business

Qualstar Corporation and its Subsidiaries (“Qualstar”, the “Company”, “we”, “us” or “our”) is organized into two strategic business segments, power solutions and data storage systems. Qualstar is a leading provider of data storage systems marketed under the Qualstar brand and of high efficiency and high-density power solutions marketed under the N2Power brand. Qualstar’s N2Power branded power solutions products provide unique power solutions to original equipment manufacturers (“OEMs”) for a wide range of markets, including communications networking, industrial, gaming, test equipment, lighting, medical as well as other market applications. Data storage system products include highly scalable automated magnetic tape-based storage solutions used to store, retrieve and manage electronic data primarily in the network computing environment and to provide solutions for organizations requiring backup, recovery and archival storage of critical electronic information.

Qualstar Corporation was incorporated in California in 1984 and has four wholly owned subsidiaries. The N2Power, Inc. subsidiary (N2Power) operates the Company’s power supplies business. The Qualstar Corporation Singapore Private Limited subsidiary gives the Company an engineering footprint in Singapore, and participates in serving our Asian contract manufacturers, distribution partners, and customers. The Qualstar Limited subsidiary expands the Company’s data storage business in Europe and Africa. And, the Q-Smart Data Private Limited subsidiary pursues new business opportunities in Asia.

We sell our products globally through authorized resellers, distributers, and directly to OEMs. N2Power utilizes contract manufacturers in Asia to produce our power solutions products. Our storage products are manufactured by our OEM suppliers in other parts of the world and configured to order by us at our facility in Camarillo, California.

Basis of Presentation

The accompanying condensed consolidated balance sheet as of December 31, 2019, has been derived from audited consolidated financial statements. The accompanying unaudited interim condensed consolidated financial statements as of and for the three and nine month periods ended September 30, 2020 have been prepared on the same basis as our annual audited consolidated financial statements and in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial statements.

Preparing condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Examples include estimates of loss contingencies, product life cycles and inventory obsolescence, bad debts, sales returns, share-based compensation, forfeiture rates, the potential outcome of future tax consequences of events that have been recognized in our financial statements or tax returns and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management’s estimates and assumptions.

The Company's significant accounting policies are disclosed in Note 1 to the Consolidated Financial Statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2019, filed with the SEC on March 19, 2020. There were no material changes to the significant accounting policies during the nine months ended September 30, 2020.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Principles of Consolidation

The condensed consolidated financial statements include our accounts and the accounts of each of our wholly owned subsidiaries that were in existence during the periods presented: N2Power, Inc., Qualstar Corporation Singapore Private Limited, Qualstar Limited and Q-Smart Data Private Limited. All significant intercompany accounts and transactions have been eliminated in consolidation.

Estimates and Assumptions

Preparing financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include estimates of loss contingencies, product life cycles and inventory obsolescence, bad debts, sales returns, warranty costs, share-based compensation forfeiture rates, the tax consequences of events that have been recognized in our consolidated financial statements or tax returns and determining when investment impairments are other-than-temporary. Actual results and outcomes may differ from management's estimates and assumptions.

COVID-19 Pandemic

Public health threats continue to have an adverse effect on our operations and financial results. The outbreak in December 2019 of a novel coronavirus (COVID-19) in China has resulted in quarantines, restrictions on travel and other business and economic disruptions. We cannot presently and precisely predict the scope and severity of the continued business shutdowns and disruptions of our suppliers, distributors, resellers and other third parties with whom we conduct business and our ability to maintain the level of business as planned for the coming months due to COVID-19.

Revenue Recognition

The Company recognizes revenue when its customer obtains control of promised goods or services, in an amount that reflects the consideration which we expect to receive in exchange for those goods or services. To determine revenue recognition for arrangements that the Company determines are within the scope of ASC 606, we perform the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) we satisfy a performance obligation. The five-step model is applied to contracts when it is probable that we will collect the consideration we are entitled to in exchange for the goods or services transferred to the customer. At contract inception, once the contract is determined to be within the scope of ASC 606, we assess the goods or services promised within each contract and determine those that are performance obligations and assess whether each promised good or service is distinct. We then recognize revenue in the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied.

Title and risk of loss generally pass to our customers upon shipment. In limited circumstances where either title or risk of loss pass upon destination, we defer revenue recognition until such events occur. We derive revenues from two primary sources: products and services. Product revenue includes the shipment of product according to the agreement with our customers for data storage products and power supplies. Services include customer support (technical support), installations, consulting, and design services. A contract may include both product and services. Rarely, contracts with customers contain multiple performance obligations. For these contracts, the Company accounts for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. Standalone selling prices are typically estimated based on observable transactions when these services are sold on a standalone basis.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

A variety of technical services can be contracted by our customers for a designated period of time. The service contracts allow customers to call Qualstar for technical support, replace defective parts and to have onsite service provided by Qualstar's third party contract service provider. We record revenue for contract services at the amount of the service contract, but such amount is deferred at the beginning of the service term and amortized ratably over the life of the contract.

Deferred service revenue is shown separately in the condensed consolidated balance sheets as current and long term. At September 30, 2020 we had deferred service revenue of approximately $853,000. At December 31, 2019, we had deferred service revenue of approximately $949,000.

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. When legal costs that the entity expects to incur in defending itself in connection with a loss contingency accrual are expected to be material, the loss should factor in all costs and, if the legal costs are reasonably estimable, they should be accrued in accordance with ASC 450, regardless of whether a liability can be estimated for the contingency itself. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. Changes in these factors could materially impact our condensed consolidated financial statements. No loss contingency was recorded as of September 30, 2020.

Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, which include cash equivalents, accounts receivable, accounts payable, related party, and other long-term liabilities, approximate their fair values.

Accounting for Income Taxes

Income taxes are accounted for using the liability method. Under this method, deferred tax liabilities and assets are recognized for the expected future tax consequences of temporary differences between the financial statement and tax bases of assets and liabilities, and for the expected future tax benefit to be derived from tax credits and loss carry forwards. Current income tax expense or benefit represents the amount of income taxes expected to be payable or refundable for the current year. A valuation allowance is established when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Leases

The Company accounts for its leases under ASC 842, *Leases*. Under this guidance, arrangements meeting the definition of a lease are classified as operating or financing leases, and are recorded on the consolidated balance sheet as both a right-of-use asset and lease liability, calculated by discounting fixed lease payments over the lease term at the rate implicit in the lease or the Company's incremental borrowing rate. Lease liabilities are increased by interest and reduced by payments each period, and the right- of- use asset is amortized over the lease term. For operating leases, interest on the lease liability and the amortization of the right-of-use asset result in straight-line rent expense over the lease term. For finance leases, interest on the lease liability and the amortization of the right-of-use asset results in front-loaded expense over the lease term. Variable lease expenses are recorded when incurred.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

In calculating the right of use asset and lease liability, the Company has elected to combine lease and non-lease components. The Company excludes short-term leases having initial terms of 12 months or less from the new guidance as an accounting policy election and recognizes rent expense on a straight-line basis over the lease term.

Operating Segments

The Company operates in two segments, Data Storage and Power Supplies. Operating segments are identified as functional groups within an enterprise in which discrete financial information is utilized by the chief operating decision maker in allocating resources and assessing performance. In the case of Qualstar, the chief operating decision maker is its President and Chief Executive Officer. This position maintains decision-making control over, and assesses the performance of, the two divisional levels of the Company.

Recent accounting guidance not yet adopted

In December 2019, the FASB issued ASU 2019-12, *Income Taxes*, which is intended to simplify the accounting standard and improve the usefulness of information provided in the financial statements. We intend to implement this new accounting guidance effective January 1, 2021, however early adoption is permitted. we are currently assessing the impact this new accounting guidance will have on our financial statements.

NOTE 2 - BALANCE SHEET DETAILS

The following tables provide details of selected balance sheet accounts (in thousands):

Inventories

Inventories are stated at the lower of cost (first-in, first-out basis) or net realizable value. Inventories are comprised as follows (in thousands):

	September 30, 2020	December 31, 2019
Raw materials	$ 84	$ 199
Finished goods	2,891	2,341
Net inventory balance	$ 2,975	$ 2,540

Property and equipment, net

The components of property and equipment are as follows (in thousands):

	September 30, 2020	December 31, 2019
Leasehold improvements	$ 78	$ 163
Furniture and fixtures	260	268
Machinery and equipment	609	609
	947	1,040
Less accumulated depreciation and amortization	(837)	(918)
Property and equipment, net	$ 110	$ 122

NOTE 2 - BALANCE SHEET DETAILS (CONTINUED)

Depreciation and amortization expense for the three months ended September 30, 2020 and 2019 was $10,000 and $11,000, respectively. Depreciation and amortization expense for the nine months ended September 30, 2020 and 2019 was $35,000 and $35,000, respectively.

Other Accrued Liabilities

The components of other liabilities are as follows (in thousands):

	September 30, 2020	December 31, 2019
Accrued warranty	$ 167	$ 290
Accrued outside commissions	13	55
Other accrued liabilities	4	23
Total other accrued liabilities	$ 184	$ 368

NOTE 3 –CONTINGENCIES

Accrued Warranty

We provide a three-year advance replacement warranty on all XLS and RLS libraries and a two-year warranty on our Q-Series libraries. This includes replacement of components, or if necessary, complete libraries. XLS libraries sold in North America also include one year of on-site service. Customers may purchase on-site service if they are located in the United States, Canada, and selected countries in Europe, Asia Pacific and Latin America. All customers may purchase extended warranty service coverage upon expiration of the standard warranty.

We provide a three-year warranty on all power supplies that includes repair or if necessary, replacement of the power supply.

A provision for costs related to warranty expense is recorded when revenue is recognized, which is estimated based on historical warranty costs incurred.

Activity in the liability for product warranty (included in other accrued liabilities) for the periods presented is as follows (in thousands):

	Nine months Ended September 30, 2020	Year Ended December 31, 2019
Beginning balance	$ 290	$ 365
Cost of warranty claims	(9)	(21)
Accruals for product warranties, net	(114)	(54)
Ending balance	$ 167	$ 290

NOTE 4 –EARNINGS PER SHARE

Basic earnings per share has been computed by dividing net income or loss by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income or loss by the weighted average number of diluted common shares, which is inclusive of common stock equivalents from unexercised stock options. Unexercised stock options are considered to be common stock equivalents if, using the treasury stock method, they are determined to be dilutive.

The following table sets forth the computation of basic and diluted net income per share for the periods indicated (in thousands, except per share amounts).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Net income	$ (189)	$ 49	$ (246)	$ 179
Weighted average outstanding shares of common stock	1,925	1,922	1,925	1,967
Dilutive potential common shares from employee stock options	–	–	–	–
Common stock and common stock equivalents	1,925	1,922	1,925	1,967
Earnings per share:				
Basic earnings per share	$ (0.10)	$ 0.03	$ (0.13)	$ 0.09
Diluted earnings per share	$ (0.10)	$ 0.03	$ (0.13)	$ 0.09

For the three months ended September 30, 2020 and 2019, 155,633 and 161,333 outstanding stock options were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive. For the nine months ended September 30, 2020 and 2019, 161,333 and 176,000 outstanding stock options were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive.

NOTE 5 –SHARE-BASED COMPENSATION AND STOCK INCENTIVE PLANS

Share-Based Compensation

The Company did not incur expense for share-based compensation associated with outstanding stock options for the three and nine month periods ended September 30, 2020 and 2019. No income tax benefit was recognized in the condensed consolidated statements of operations for share-based arrangements in any period presented. At September 30, 2020, the Company did not have any unrecognized compensation costs related to share-based compensation.

Stock Incentive Plans

The Company has two stock incentive plans as described below.

Qualstar adopted the 2008 Stock Incentive Plan (the "2008 Plan") under which incentive and nonqualified stock options and restricted stock could be granted for shares of common stock. The 2008 Plan has expired, and no additional options may be granted under that plan. However, 20,000 options that were previously granted under the 2008 Plan will continue under their terms.

NOTE 5 –SHARE-BASED COMPENSATION AND STOCK INCENTIVE PLANS (CONTINUED)

The 2017 Stock Incentive Plan (the "2017 Plan") permits the award of stock options (both incentive and non-qualified options), stock appreciation rights, restricted stock, restricted stock units, unrestricted stock, performance shares, dividend equivalent rights and cash-based awards to employees (including executive officers), directors and consultants of the Company and its subsidiaries. The 2017 Plan authorizes the issuance of an aggregate of 300,000 shares of common stock and the plan is administered by the Compensation Committee of the Company's Board of Directors.

With respect to options, the fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses various assumptions, such as volatility, expected term and risk-free interest rate. Expected volatilities are based on the historical volatility of the Company's stock. The Company uses historical data to estimate option exercise and employee termination in determining forfeiture rates. The expected term of options granted is estimated based on the vesting term of the award, historical employee exercise behavior, expected volatility of the Company's stock and an employee's average length of service. The risk-free interest rate used in this model correlates to a U.S. constant rate Treasury security with a contractual life that approximates the expected term of the option award.

The following table summarizes stock option activity:

	Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2019	161,333	$ 7.17	7.49	—
Granted	—	—	—	—
Exercised	—	—	—	—
Forfeited, canceled or expired	(15,700)	7.08	—	—
Outstanding at September 30, 2020	145,633	7.18	6.73	—
Exercisable at September 30, 2020	145,633	$ 7.18	6.73	$ —

NOTE 6 – INCOME TAXES

We did not record an income tax provision or benefit for the three and nine month periods ended September 30, 2020 and 2019, as the Company has net operating loss carryforwards available to offset taxable income. The 2017 federal tax return was examined in 2019 and provided a no change notice by the Internal Revenue Service.

NOTE 7 – SIGNIFICANT CUSTOMERS, CONCENTRATION OF CREDIT RISK, AND GEOGRAPHIC INFORMATION

We have no outstanding debt nor do we utilize auction rate securities or derivative financial instruments in our investment portfolio. Cash and other investments may be in excess of FDIC insurance limits.

Our financial results could be affected by changes in foreign currency exchange rates or weak economic conditions in foreign markets. As all sales are currently made in U.S. dollars, a strengthening of the dollar could make our products less competitive in foreign markets.

NOTE 7 – SIGNIFICANT CUSTOMERS, CONCENTRATION OF CREDIT RISK, AND GEOGRAPHIC INFORMATION (CONTINUED)

The following table summarizes revenue by geographic area (in thousands, except percentages):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2020		2019		2020		2019	
North America	$ 1,246	67.2 %	$ 2,267	61.2%	$ 3,312	56.9 %	$ 6,184	61.9 %
Europe	454	24.5 %	418	11.3%	1,723	29.6 %	1,195	11.9 %
Asia Pacific	137	7.4 %	1,016	27.4%	747	12.8 %	2,576	25.8 %
Other	18	1.0 %	2	0.1%	35	0.6 %	43	0.4 %
	$ 1,855	100.0 %	$ 3,703	100.0%	$ 5,817	100.0 %	$ 9,998	100.0 %

One customer accounted for 10.3% of the Company's net revenue for the three-month period ended September 30, 2020. Two customers accounted for 20.7% and 11.0% of the Company's net revenue for the three-month period ended September 30, 2019.

No customers accounted for greater than 10% of the Company's net revenue for the nine-month period ended September 30, 2020. Two customers accounted for 23.5% and 11.0% of the Company's net revenue for the nine-month period ended September 30, 2019.

NOTE 8 – COMMITMENTS

Lease Agreements

The Company entered into a lease for a facility in Camarillo, California beginning June 1, 2019. The facility is 9,910 square feet and is a 5-year and two-month lease, expiring July 31, 2024. The rent on this facility is $9,910 per month with a 3% step-up annually. Qualstar subleases a portion of the warehouse space to Interlink Electronics, Inc. ("Interlink") and BKF Capital Group, Inc. ("BKF Capital") and is reimbursed for the space and other related expenses on a monthly basis. As described in Note 10, Interlink and BKF Capital are related parties.

The Company subleases its corporate office in Irvine from Interlink Electronics, Inc. ("Interlink") under an oral agreement, pursuant to which the Company pays rent of approximately $2,000 per month.

Qualstar leases a 15,160 square foot facility located in Simi Valley, California. The three-year lease began December 15, 2014 and has been renewed for an additional three years, expiring February 28, 2021. Rent on this facility is $11,400 per month with a step-up of 3% annually. On May 22, 2019, Qualstar entered into a sublease agreement with Stillwater Agency, Inc. ("Stillwater"), for the Simi Valley facility. The term of that sublease commenced on July 15, 2019 and ends on February 28, 2021. The base rent under the sublease is approximately $12,886 per month. Stillwater is also responsible for approximately nine percent of certain operating expenses and taxes associated with the office building in which the leased premises are located. Prior to entering the sublease, Qualstar subleased a portion of the warehouse space to Interlink and was reimbursed for the space and other related expenses on a monthly basis.

Qualstar also previously leased approximately 5,400 square feet of office space in Westlake Village, California, that expired January 31, 2020, and was not renewed. Rent on this facility was $11,000 per month, with a step-up of 3% annually. Effective March 21, 2016, Qualstar entered into a sublease agreement for the Westlake Village facility. The term of the sublease expired at the same time as the term of the master lease and the tenant paid Qualstar $12,000 per month with a step-up of 3% annually.

NOTE 8 – COMMITMENTS (CONTINUED)

The Company previously leased 1,359 square feet of office space in Singapore for $2,500 per month, which expired March 31, 2020. This lease was not renewed.

Such leases do not require any contingent rental payments, impose any financial restrictions, or contain any residual value guarantees. Variable expenses generally represent the Company's share of the landlord's operating expenses. The Company does not have any leases classified as financing leases.

The rate implicit in each lease is not readily determinable, and we therefore use our incremental borrowing rate to determine the present value of the lease payments. The weighted average incremental borrowing rate used to determine the initial value of right-of-use (ROU) assets and lease liabilities during the nine months ended September 30, 2020 was 4.33%, derived from borrowing rate quotes as obtained from the Company's business bank. We have certain contracts for real estate which may contain lease and non-lease components which we have elected to treat as a single lease component.

Right of use assets for operating leases are periodically reduced by impairment losses. We use the long-lived assets impairment guidance in ASC Subtopic 360-10, *Property, Plant, and Equipment – Overall*, to determine whether a ROU asset is impaired, and if so, the amount of the impairment loss to recognize. As of September 30, 2020, we have not recognized any impairment losses for our ROU assets.

We monitor for events or changes in circumstances that require a reassessment of our leases. When a reassessment results in the remeasurement of a lease liability, a corresponding adjustment is made to the carrying amount of the corresponding ROU asset unless doing so would reduce the carrying amount of the ROU asset to an amount less than zero. In that case, the amount of the adjustment that would result in a negative ROU asset balance is recorded in profit or loss.

At September 30, 2020, the Company had current and long-term operating lease liabilities of $230,000 and $283,000, respectively, and right-of-use assets of $487,000.

Future minimum lease payments under these leases are as follows, in thousands:

	Minimum Lease Payment	Sublease Income	Net Minimum Lease Payment
Remainder of 2020	$ 65	$ (39)	$ 26
2021	148	(26)	122
2022	129	–	129
2023	133	–	133
2024	79	–	79
After	–	–	–
Total undiscounted future non-cancelable minimum lease payments	554	(65)	489
Less: Imputed interest	(41)	–	(41)
Present value of lease liabilities	$ 513	$ (65)	$ 448

Net rent expense for the three months ended September 30, 2020 and 2019 was $62,000 and $45,000, respectively. Net rent expense for the nine months ended September 30, 2020 and 2019 was $122,000 and $129,000, respectively.

NOTE 9 – SEGMENT INFORMATION

In its operation of the business, management reviews certain financial information, including segmented internal profit and loss statements prepared on a basis consistent with GAAP. Our two segments are Power Supplies and Data Storage. The two segments discussed in this analysis are presented in the way we internally manage and monitor performance for the three and nine months ended September 30, 2020 and 2019. Our allocations of internal resources were made to the two business segments for the three and nine months ended September 30, 2020 and 2019. The types of products and services provided by each segment are summarized below:

Power Supplies — The Company designs and markets high-efficiency switching power supplies. We utilize contract manufacturers in Asia to produce the power supplies products. These power supplies are used to convert AC line voltage to DC voltages, or DC voltages to other DC voltages for use in a wide variety of electronic equipment such as communications equipment, industrial machine tools, wireless systems, as well as medical and gaming devices. We sell our products globally through authorized resellers and directly to original equipment manufacturers.

Storage — The data storage industry is experiencing a tremendous increase in newly generated digital data due to Rich Media Content, Internet of Things, Data Mining and the Cloud. Tape based storage solution providers enable businesses to manage the massive growth of digital data assets in a cost-effective manner. Our tape-based data storage product lines address long-term archive, backup and recovery of electronic data. These products consist of networked libraries that store and move high-density tape cartridges and high-speed tape drives that stream data to and from the tape cartridges. These optimized solutions allow the video centric markets such as media and entertainment, oil and gas, surveillance, digital security and medical imaging to achieve targeted data workflows.

Segment revenue, income before taxes and total assets were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	**2019**	**2020**	**2019**
Revenue				
Power Supplies	$ 553	$ 1,450	$ 1,951	$ 4,117
Storage:				
Product	980	1,148	2,645	3,060
Service	322	1,105	1,221	2,821
Total storage	1,302	2,253	3,866	5,881
Revenue	$ 1,855	$ 3,703	$ 5,817	$ 9,998

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	**2019**	**2020**	**2019**
Income (Loss) before Taxes				
Power Supplies	$ (296)	$ (141)	$ (649)	$ (497)
Storage	107	190	403	676
Income (loss) before taxes	$ (189)	$ 49	$ (246)	$ 179

NOTE 9 – SEGMENT INFORMATION (CONTINUED)

	September 30, 2020	December 31, 2019
Total Assets		
Power Supplies		
Cash and cash equivalents	$ 518	$ 527
Accounts receivable, net	261	840
Inventories	1,347	872
Prepaid expenses and other current assets	98	107
Property and equipment, net	3	11
Total Power Supplies assets	2,227	2,357
Storage		
Cash and cash equivalents	4,198	3,336
Restricted cash	100	100
Accounts receivable, net	473	1,526
Inventories	1,628	1,668
Prepaid expenses and other current assets	140	104
Property and equipment, net	107	111
Right-of-use assets	487	676
Other assets	57	160
Total Storage assets	7,190	7,681
Total Assets	$ 9,417	$ 10,038

NOTE 10 – RELATED PARTY TRANSACTIONS

Steven N. Bronson is the Company's CEO and is also the President and CEO and a majority shareholder of Interlink Electronics, Inc. and BKF Capital Group, Inc. The Company and Interlink have entered into shared services arrangements for marketing, executive and finance support services. In addition, the Company entered into cost sharing arrangements with Interlink for the facilities we are sharing based upon the headcounts and square footages. The transactions with Interlink are as follows.

	Three months ended September 30,			
	2020		2019	
	Due to Interlink	Due from Interlink	Due to Interlink	Due from Interlink
	(in thousands)			
Balance at June 30,	$ 48	$ 7	$ 1	$ 1
Billed to Interlink by Qualstar	–	18	–	15
Paid by Interlink to Qualstar	–	(20)	–	(9)
Billed to Qualstar by Interlink	127	–	43	–
Paid by Qualstar to Interlink	(162)	–	(31)	–
Balance at September 30,	$ 13	$ 5	$ 13	$ 7

NOTE 10 – RELATED PARTY TRANSACTIONS (CONTINUED)

	Nine months ended September 30,			
	2020		2019	
	Due to Interlink	Due from Interlink	Due to Interlink	Due from Interlink
	(in thousands)			
Balance at January 1,	$ 24	$ 12	$ 3	$ 2
Billed to Interlink by Qualstar	–	71	–	25
Paid by Interlink to Qualstar	–	(78)	–	(20)
Billed to Qualstar by Interlink	381	–	157	–
Paid by Qualstar to Interlink	(392)	–	(147)	–
Balance at September 30,	$ 13	$ 5	$ 13	$ 7

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

OVERVIEW

Qualstar Corporation and its Subsidiaries ("Qualstar", the "Company", "we", "us" or "our") manufactures and markets data storage system products and compact, high efficiency power solutions. Our data storage devices include highly scalable automated magnetic tape libraries used to store, retrieve and manage electronic data primarily in the network computing environment. Our data storage devices include models ranging from entry level to enterprise and are a cost-effective solution for organizations requiring backup, recovery and archival storage of critical electronic information. The distribution channels for our data storage devices include resellers, system integrators, and original equipment manufacturers ("OEMs"). In addition, the Company is a leading provider of standard, semi-custom and custom power solutions marketed under the N2Power brand. Our power solution products provide OEM designers increased functionality while reducing thermal loads and cooling requirements and lowering operating costs. Our power solution products are currently sold to OEMs in a wide range of markets, including telecom/networking equipment, audio/visual, industrial, gaming and now medical with our new product offerings.

The Company is focused on expanding sales in both business units in two key areas: adding key customers and expanding its product portfolio. The data storage business is adding more strategic partners that will expand our geographic footprint and increase our reach to additional industries. The power supplies business unit recently added a new general manager and is expanding its sales team in an effort to grow its customer base in specific market verticals, such as the gaming industry. In addition to adding new internally designed and private label products, the power supplies business is focusing on providing value add services in establishing itself as an optimized product development manufacturer for current and future new customers. This will allow N2Power to act as a one-stop shop providing solutions for more complex power assembly units and chassis solutions for their OEM customers.

The Company continues to expand its product portfolio through internal development, private labeling and establishing worldwide partnerships with other power supplies and data storage related companies. These new relationships will increase our product development engineering capabilities and help us stay at the forefront of both the data storage and power supplies industries.

RESULTS OF OPERATIONS - (Unaudited)

The following table is presented in thousands, except for percentages. The percentages in the table are based on net revenues.

	Three months ended September 30,				Nine months ended September 30,			
	2020		2019		2020		2019	
	$	%	$	%	$	%	$	%
	(in thousands, except percentages)				(in thousands, except percentages)			
Power supplies revenues	$ 553	29.8%	$ 1,450	39.2%	$ 1,951	33.5%	$ 4,117	41.2%
Storage revenues	1,302	70.2%	2,253	60.8%	3,866	66.5%	5,881	58.8%
Net revenues	1,855	100.0%	3,703	100.0%	5,817	100.0%	9,998	100.0%
Cost of goods sold	1,076	58.0%	2,749	74.2%	3,603	61.9%	7,319	73.2%
Gross profit	779	42.0%	954	25.8%	2,214	31.8%	2,679	26.8%
Operating expenses:								
Engineering	163	8.8%	122	3.3%	342	5.9%	473	4.7%
Sales and marketing	393	21.2%	368	9.9%	1,007	17.3%	982	9.8%
General and administrative	412	22.2%	427	11.5%	1,120	19.3%	1,078	10.8%
Total operating expenses	968	52.2%	917	24.7%	2,469	42.4%	2,533	25.3%
Income (loss) from operations	(189)	(10.2)%	37	1.0%	(255)	(4.4)%	146	1.5%
Other income (expense) , net	–	0.0%	12	0.3%	9	0.2%	33	0.3%
Net income (loss)	$ (189)	(10.2)%	$ 49	1.3%	$ (246)	(4.2)%	$ 179	1.8%

Net Revenues:

	Three months Ended September 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Power supplies revenues	$ 553	29.8 %	$ 1,450	39.2 %	$ (897)	(61.9)%
Storage revenues	1,302	70.2 %	2,253	60.8 %	(951)	(42.2)%
Net revenues	$ 1,855	100.0 %	$ 3,703	100.0 %	$ (1,848)	(49.9)%

	Nine months Ended September 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Power supplies revenues	$ 1,951	33.5 %	$ 4,117	41.2 %	$ (2,166)	(52.6)%
Storage revenues	3,866	66.5 %	5,881	58.8 %	(2,015)	(34.2)%
Net revenues	$ 5,817	100.0 %	$ 9,998	100.0 %	$ (4,181)	(41.8)%

The decrease in net revenues for the three and nine months ended September 30, 2020 compared to the prior year periods is attributable to the segment-specific factors described below.

Segment Revenue

Power Supplies – The decrease in power supplies sales in the three and nine months ended September 30, 2020 compared to the prior year period is primarily attributable to the COVID-19 pandemic. Initially, the extended Chinese New Year halted production with our contract manufacturer in China. As China went back into production, many of our customers in the United States and abroad were shut down. The limited demand for our power supplies has continued with customers that manufacture critical products or are in geographic areas that are not on lock down.

Storage – For the three and nine months ended September 30, 2020 compared to the prior year period we experienced a decline in our storage product sales primarily attributable to the COVID-19 pandemic as businesses globally were locked down. Service revenue also decreased as a result of the termination of our partnership with Sony Imaging Products & Solutions Inc. for the development of an enterprise class optical disk archive library, and also as a result of declines of approximately 10% in technical support revenue for both the three and nine month periods ended September 30, 2020. For the three and nine months ended September 30, 2020, we are still facing the weak market worldwide as a result of COVID-19.

Gross Profit:

	Three months Ended September 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Gross profit	$ 779	42.0 %	$ 954	25.8 %	$ (175)	(18.3)%

	Nine months Ended September 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Gross profit	$ 2,214	36.9 %	$ 2,679	26.8 %	$ (465)	(17.3)%

The gross profit decrease for the three months and nine months ended September 30, 2020 compared to the prior year periods is primarily attributed to our reduced net revenue. The reduced revenue did not contribute the same margins to apply to the fixed costs of the business as in the prior year. The increase in gross margin percentage for the three months and nine months ended September 30, 2019 compared to the prior year periods is primarily attributed to the change in mix between power supplies products and storage products.

Operating Expenses:

	Three months Ended September 30,				Change	
	2020		2019			
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Engineering	$ 163	8.8 %	$ 122	3.3 %	$ 41	33.6%
Sales and marketing	393	21.2 %	368	9.9 %	25	6.8%
General and administrative	412	22.2 %	427	11.5 %	(15)	(3.5)%
Total operating expenses	$ 968	52.2 %	$ 917	24.7 %	$ 51	5.6%

	Nine months Ended September 30,				Change	
	2020		2019			
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Engineering	$ 342	5.9 %	$ 473	4.7 %	$ (131)	(27.7)%
Sales and marketing	1,007	17.3 %	982	9.8 %	25	2.5%
General and administrative	1,120	18.8 %	1,078	10.8 %	42	3.9%
Total operating expenses	$ 2,469	41.9 %	$ 2,533	25.3 %	$ (64)	(2.5)%

Engineering

Engineering expenses increased for the three months ended September 30, 2020 compared to the prior year primarily due to an increase in employees in the storage segment. Engineering expenses decreased for the nine months ended September 30, 2020 compared to the prior year primarily due to a reduction of employees in the power supplies segment.

Sales and Marketing

Sales and marketing expenses were relatively consistent for the three months and nine months ended September 30, 2020 compared to the prior year periods.

General and Administrative

General and administrative expenses were relatively consistent for the three months and nine months ended September 30, 2020 compared to the prior year periods.

Other income

Other income decreased as a result of less interest earned during the three and nine months ended September 30, 2020 compared to the corresponding periods in the prior year.

Provision for Income Taxes

We did not record a provision or benefit for income taxes for each of the three months and nine months ended September 30, 2020 and 2019, due to our net operating loss carryforwards. There were no changes to the valuation allowance during the nine months ended September 30, 2020.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2020, cash, cash equivalents, and restricted cash increased $853,000 to $4,816,000 from $3,963,000 at December 31, 2019.

Operating Activities

Our principal source of liquidity is cash generated from operations. Net cash provided by operating activities was $618,000 for the nine months ended September 30, 2020, compared to net cash provided by operating activities of $211,000 for the nine months ended September 30, 2019. Net cash used in operating activities was $67,000 for the three months ended September 30, 2020, compared to net cash provided by operating activities of $53,000 for the three months ended September 30, 2019.

Cash provided by operating activities for the nine months ended September 30, 2020 of $618,000 consisted of net loss of ($246,000), plus $210,000 of non-cash adjustments and $654,000 of proceeds from changes in operating assets and liabilities. Cash used in operating activities for the three months ended September 30, 2020 of ($67,000) consisted of net loss of ($189,000), plus $87,000 of non-cash adjustments and $35,000 of proceeds from changes of operating assets and liabilities. Cash provided by the change in operating assets and liabilities was primarily due to the reductions of accounts receivable for both the three and nine months ended September 30, 2020.

Investing Activities
Cash used for investing activities for the nine months ended September 30, 2020 was $23,000 relating to the purchase of a new tradeshow booth and leasehold improvements on the Camarillo facility. No cash was used for investing activities for the three months ended September 30, 2020.

Financing Activities
Cash provided by financing activities for the nine months ended September 30, 2020 was from a loan in the amount of $258,000 that we received pursuant to the Paycheck Protection Program (the "PPP") under the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), which was enacted March 27, 2020. In May 2020, we received a loan from Wells Fargo Bank in the aggregate principal amount of $258,000 pursuant to the PPP. The loan is evidenced by a promissory note, dated May 4, 2020, issued by us to the lender, which note matures on May 3, 2022, and bears interest at a rate of 1.00% per annum, payable monthly commencing on November 11, 2020, following an initial deferral period as specified under the PPP. We may prepay the note at any time prior to maturity with no prepayment penalties. Proceeds from the loan were used to fund designated expenses, including certain payroll costs, group health care benefits and other permitted expenses, in accordance with the PPP. Under the terms of the PPP, up to the entire amount of principal and accrued interest may be forgiven to the extent loan proceeds are used for qualifying expenses as described in the CARES Act and applicable implementing guidance issued by the U.S. Small Business Administration under the PPP. We intend to apply for forgiveness of all or a substantial portion of the loan in accordance with the terms of the PPP. No assurance can be given that we will obtain forgiveness of the loan in whole or in part. With respect to any portion of the loan that is not forgiven, the loan is subject to customary provisions for a loan of this type, including customary events of default relating to, among other things, payment defaults and breaches of the note's provisions.

We believe that our existing cash and cash equivalents and cash flows from our operating activities will be sufficient to fund our working capital and capital expenditure needs for at least twelve months from the date of this report. We may utilize cash to invest in or acquire businesses, products or technologies that we believe are additive to the strategic expansion of the Company. We periodically evaluate other companies and technologies for possible investment or acquisition. In addition, we have made, and may in the future make, investments in companies with whom we have identified potential synergies. However, we have no present commitments or agreements with respect to any material investment in or acquisition of other businesses or technologies. In the event that we require additional capital to meet our business needs, there can be no assurance that additional funding will be available to us when needed or, if available, that it can be obtained on commercially reasonable terms.