QUALSTAR CORP
Form 10-Q
May 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2018

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 001-35810

QUALSTAR CORPORATION

(Exact name of registrant as specified in its charter)

CALIFORNIA	**95-3927330**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

130 West Cochran Street, Unit C, Simi Valley, CA 93065

(Address of principal executive offices) (zip code)

(805) 583-7744

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
(do not check if smaller reporting company)	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with the new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act.

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

At May 1, 2018 the issuer had 2,048,118 shares of common stock, no par value, issued and outstanding.

QUALSTAR CORPORATION

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2018

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PART I — FINANCIAL INFORMATION

ITEM 1. Financial Statements

QUALSTAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	March 31, 2018 (Unaudited)	**December 31, 2017**
Assets		
Current assets:		
Cash and cash equivalents	$ *5,231*	$ *4,698*
Restricted cash	*100*	*100*
Accounts receivables, net	*1,979*	*1,802*
Inventories, net	*1,611*	*1,564*
Prepaid expenses and other current assets	*173*	*163*
Total current assets	*9,094*	*8,327*
Non-current assets:		
Property and equipment, net	*141*	*172*
Other assets	*67*	*68*
Total assets	$ *9,302*	$ *8,567*
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ *803*	$ *1,065*
Accrued payroll and related liabilities	*167*	*173*
Deferred service revenue, short-term	*1,234*	*834*
Other accrued liabilities	*439*	*454*
Total current liabilities	*2,643*	*2,526*
Long-term liabilities:		
Other long-term liabilities	*52*	*52*

Deferred service revenue	*87*	*93*
Total long-term liabilities	*139*	*145*
Total liabilities	*2,782*	*2,671*
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 2,048,118 at March 31, 2018 and 2,042,019 shares at December 31, 2017	*19,514*	*19,480*
Accumulated deficit	*(12,994)*	*(13,584)*
Total shareholders' equity	*6,520*	*5,896*
Total liabilities and shareholders' equity	$ *9,302*	$ *8,567*

See notes to condensed consolidated financial statements.

QUALSTAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	Three Months Ended	
	March 31,	
	2018	**2017**
Net revenues	$*2,935*	$*2,439*
Cost of goods sold	*1,507*	*1,549*
Gross profit	*1,428*	*890*
Operating expenses:		
Engineering	*121*	*186*
Sales and marketing	*295*	*247*
General and administrative	*422*	*399*
Total operating expenses	*838*	*832*
Income from operations	*590*	*58*
Other expenses	-	-
Income before income taxes	*590*	*58*
Provision for income taxes	-	-
Net Income	$*590*	$*58*
Earnings per share:		
Basic	$*0.29*	$*0.03*
Diluted	$*0.28*	$*0.03*
Shares used in per share calculation:		
Basic	*2,048*	*2,042*
Diluted	*2,101*	*2,042*

See notes to condensed consolidated financial statements.

QUALSTAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Three Months Ended March 31,	
	2018	**2017**
Cash flows from operating activities:		
Net income	$*590*	$*58*
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	*30*	*44*
Provision for inventory obsolescence	*87*	*73*
Changes in operating assets and liabilities:		
Accounts receivable	*(177)*	*(363)*
Inventories	*(134)*	*160*
Prepaid expenses and other current assets	*(8)*	*4*
Accounts payable	*(262)*	*65*
Accrued payroll and related liabilities	*(6)*	*(55)*
Deferred service revenue	*394*	*99*
Other accrued liabilities	*(15)*	*(34)*
Total adjustments	*(91)*	*(7)*
Net cash provided by operating activities	*499*	*51*
Cash flows from investing activities:		
Proceeds from the exercise of stock options	*34*	*-*
Purchases of equipment	*-*	*(2)*
Net cash provided by (used in) investing activities	*34*	*(2)*
Net increase in cash, restricted cash and cash equivalents	*533*	*49*
Cash, restricted cash and cash equivalents at beginning of period	*4,798*	*3,791*
Cash, restricted cash and cash equivalents at end of period	$*5,331*	$*3,840*
Supplemental cash flow disclosures:		
Income taxes paid	$-	$*1*

See notes to condensed consolidated financial statements.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

NOTE *1* – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated balance sheet as of *December 31, 2017,* has been derived from audited consolidated financial statements. The accompanying unaudited interim condensed consolidated financial statements 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.

On *June 5, 2017,* a wholly-owned subsidiary of Qualstar Corporation, *N2Power,* Inc., was created to operate the Company's internal business unit known as *N2Power.* The *N2Power* business unit is reflected in the Company's SEC filings under the power supplies business segment. Following the establishment of *N2Power,* Inc., all assets (and liabilities) belonging to this subsidiary have been separated from the assets (and liabilities) of Qualstar.

The Company's significant accounting policies are disclosed in Note 2 to the Consolidated Financial Statements included in the Annual Report. There were no material changes to the significant accounting policies during the three months ended March 31, 2018, apart from the Company's accounting policy related to revenue recognition, as discussed below.

Effective January 1, 2018, the Company adopted Accounting Standards Codification ("ASC") 606, *Revenue from Contracts with Customers* ("ASC 606" or the "New Revenue Standard"), the new standard on revenue from contracts with customers, which codified Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers* ("ASU 2014-09"). As a result, the Company changed its accounting policy for revenue recognition to ensure compliance with ASC 606 and is described below.

Principles of Consolidation

The condensed consolidated financial statements include our accounts and the accounts of each of our wholly owned subsidiaries in Qualstar Corporation Singapore Private Limited and *N2Power,* Inc. All significant intercompany accounts and transactions have been eliminated in consolidation.

Interim results are *not* necessarily indicative of results for a full year. The information included in this Form *10*-Q should be read in conjunction with information included in the Qualstar Corporation Annual Report on Form *10*-K for the year ended *December 31, 2017,* filed with the SEC on *March 16, 2018.*

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

Revenue Recognition

We recognize revenue in accordance with Accounting Standards Codification ("ASC") 606, "Revenue Recognition," when there is persuasive evidence that an arrangement exists, title and risk of loss have passed, delivery has occurred or the services have been rendered, the sales price is fixed or determinable and collection of the related receivable is reasonably assured. 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 or acceptance or when collection is not reasonably assured, 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.

The Company provides product warranties with varying lengths of time and terms. The product warranties are considered to be assurance-type in nature and do not cover anything beyond ensuring that the product is functioning as intended. Based on the guidance in ASC 606, assurance-type warranties do not represent separate performance obligations. The Company also sells separately-priced maintenance service contracts which qualify as service-type warranties and represent separate performance obligations. The Company has historically experienced a low rate of product returns under the warranty program.

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. The Company records revenues 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.

The Company's professional services include consulting, engineer and design services. Because control transfers over time, revenue is recognized based on progress toward completion of the performance obligation. The method to measure progress toward completion requires judgment and is based on the nature of the products or services to be provided. The Company generally uses the input method to measure progress for its contracts because it best depicts the transfer of assets to the customer, which occurs as the Company incurs costs for the contracts. Under the cost-to-cost measure of progress, the progress toward completion is measured based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. Revenue is recorded proportionally as costs are incurred. Costs to fulfill these obligations include labor and subcontractor costs.

Deferred service revenue is shown separately in the condensed consolidated balance sheets as current and long term. At *March 31, 2018* we had deferred service revenue of approximately *$1,321,000.* At *December 31, 2017,* we had deferred service revenue of approximately *$927,000.*

Allowance for Doubtful Accounts

We estimate our allowance for doubtful accounts based on an assessment of the collectability of specific accounts and the overall condition of accounts receivable. In evaluating the adequacy of the allowance for doubtful accounts, specific trade receivables, historical bad debts, customer credits, customer credit-worthiness and changes in customers' payment terms and patterns are analyzed. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make additional payments, then additional allowances *may* be needed. Likewise, if it is determined that more of our receivables *may* be realized in the future than previously estimated, we would adjust the allowance to increase income in the period of this determination.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

Inventory Valuation

We record inventories at the lower of cost (*first*-in, *first*-out basis) or net realizable value. We assess the value of our inventories periodically based upon numerous factors including expected product or material demand, current market conditions, technological obsolescence, current cost and net realizable value. If necessary, we write down our inventory for estimated obsolescence, potential shrinkage, or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If technology changes more rapidly than expected, or market conditions become less favorable than those projected by management, additional inventory write-downs *may* be required.

Warranty Obligations

We provide for the estimated cost of product warranties at the time the related revenue is recognized. We engage in extensive product quality programs and processes, including active monitoring and evaluation of product failure rates, material usage and estimation of service delivery costs incurred in correcting a product failure. However, should actual product failure rates, material usage, or service delivery costs differ from our estimates, then revisions to the estimated warranty liability would be required. Historically, our warranty costs have *not* been significant.

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.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation, with *no* changes to previously reported stockholder's equity or net income (loss).

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.

Share-Based Compensation

Share-based compensation is accounted for in accordance with ASC *718,* "Compensation – Stock Compensation." The Black-Scholes option-pricing model is used to determine fair value of the award at the date of grant and recognize compensation expense over the vesting period. The inputs for the model require the use of judgment, estimates and assumptions regarding the expected volatility of the stock, the expected term the average employee will hold the option prior to the date of exercise, expected future dividends, and the number of share-based awards that are expected to be forfeited. Changes in these inputs and assumptions could occur and actual results could differ from these estimates, and our results of operations could be impacted.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

Accounting for Income Taxes

We estimate our tax liabilities based on current tax laws in the statutory jurisdictions in which we operate in accordance with ASC *740,* "Income Taxes." These estimates include judgments about deferred tax assets and liabilities resulting from temporary differences between assets and liabilities recognized for financial reporting purposes and such amounts recognized for tax purposes, as well as about the realization of deferred tax assets. We *may* recognize the tax benefit from an uncertain tax position only if it is more likely than *not* that the tax position will be sustained upon examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than *50%* likelihood of being realized upon ultimate settlement. ASC *740* also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures.

We maintain a valuation allowance to reduce our deferred tax assets due to the uncertainty surrounding the timing of realizing the benefits of net deferred tax assets in future years. We have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for such a valuation allowance. In the event we were to determine that we would be able to realize all or part of our net deferred tax asset in the future, the valuation allowance would be decreased accordingly.

We *may* periodically undergo examinations by the federal and state regulatory authorities and the Internal Revenue Service. We *may* be assessed additional taxes and/or penalties contingent on the outcome of these examinations. Our previous examinations have *not* resulted in any unfavorable or significant assessments.

Operating Segments

The Company operates in two segments, as the chief operating decision maker makes decisions and assesses performance at the divisional level. Operating segments are identified as components of an enterprise about which separate discrete financial information is utilized for evaluation by the chief operating decision maker in making

decisions regarding resource allocation and assessing performance. To date, the chief operating decision maker has made such decisions and assessed performance at the two divisional levels. The Company's chief operating decision maker is its President and Chief Executive Officer.

NOTE *2* – RECENT ACCOUNTING PRONOUNCEMENTS

Recent accounting guidance not yet adopted

In *February 2018,* the FASB issued ASU *2018-02* to provide guidance related to adjustments for deferred tax assets and liabilities based on the changes created by the U.S. federal government tax bill enacted *December 22, 2017.* This standard is effective for fiscal years beginning after *December 15, 2018.* We are evaluating the impact ASU *2018-02 may* have on our condensed consolidated financial statements.

In *February 2016,* the FASB issued ASU *2016-02* to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. For related party leases, the basis will be the legally enforceable terms and conditions of the arrangement. This standard is effective for fiscal years beginning after *December 15, 2018.* We are evaluating the impact ASU *2016-02 may* have on our condensed consolidated financial statements.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

NOTE *3* – 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.

	Three Months Ended March 31,			
	2018		**2017**	
	(unaudited)		**(unaudited)**	
Revenue – geographic activity (in thousands):				
North America	$*1,577*	*53.8 %*	$*1,544*	*63.3 %*
Europe	*312*	*10.6 %*	*470*	*19.3 %*
Asia Pacific	*1,022*	*34.8 %*	*403*	*16.5 %*
Other	*24*	*0.8 %*	*22*	*0.9 %*
	$*2,935*	*100.0%*	$*2,439*	*100.0%*

Two customers accounted for 23.5% and 11.0% of the Company's net revenue for the three months ended March 31, 2018. The accounts receivable balances associated with these customers totaled 32.8% and 9.7% of net accounts receivable as of March 31, 2018. The accounts receivable balances totaled 20.8% and 8.9% of net accounts receivable for the same customers as of December 31, 2017. Two different customers accounted for 20.1% and 14.0% of the Company's net revenue for the three months ended March 31, 2017.

NOTE *4* – NET EARNINGS PER SHARE

Basic net earnings per share has been computed by dividing net income or loss by the weighted average number of common shares outstanding. Diluted net earnings per share has been computed by dividing net earnings by the weighted average common shares outstanding plus dilutive securities or other contracts to issue common stock as if these securities were exercised or converted to common stock.

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

	Three Months Ended March 31,	
	2018	2017
	(unaudited)	(unaudited)
Net Income (a)	$*590*	$ *58*
Weighted average outstanding shares of common stock (b)	*2,048*	*2,042*
Dilutive potential common shares from employee stock options	*53*	—
Common stock and common stock equivalents (c)	*2,101*	*2,042*
Income per share:		
Basic net income per share (a)/(b)	$*0.29*	$ *0.03*
Diluted net income per share (a)/(c)	$*0.28*	$ *0.03*

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

For the *three* months ended *March 31, 2018* and *2017, 4,666* and *23,333* outstanding stock options, respectively, were excluded from the calculation of diluted net income per share as their inclusion would have been anti-dilutive.

NOTE *5* - 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):

	March 31, 2018	**December 31, 2017**
	(unaudited)	
Raw materials	$ *94*	$ *55*
Finished goods	*1,517*	*1,509*
Net inventory balance	$ *1,611*	$ *1,564*

Property and equipment, net

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

March 31,

	2018	December 31, 2017
	(unaudited)	
Leasehold improvements	$ *114*	$ *114*
Furniture and fixtures	*268*	*268*
Machinery and equipment	*836*	*842*
	1,218	*1,224*
Less accumulated depreciation and amortization	*(1,077)*	*(1,052)*
Property and equipment, net	$ *141*	$ *172*

Depreciation and amortization expense for the *three* months ended *March 31, 2018* and *2017* was *$30,000* and *$44,000* (unaudited), respectively.

Other Accrued Liabilities

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

	March 31, 2018	December 31, 2017
	(unaudited)	
Accrued warranty	$ *334*	$ *322*
Accrued outside commissions	*54*	*69*
Deferred rent	*28*	*29*
Other accrued liabilities	*23*	*34*
Total other accrued liabilities	$ *439*	$ *454*

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

NOTE *6* –CONTINGENCIES

Accrued Warranty

We provide for the estimated costs of hardware warranties at the time the related revenue is recognized. We estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions for tape libraries generally include parts and labor over a *three*-year period. The warranty for power supplies is generally *three* years. We regularly re-evaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

Activity in the liability for product warranty, which is included in other accrued liabilities in the condensed consolidated balance sheets for the periods presented, is as follows (in thousands):

	Three Months Ended March 31, 2018 (unaudited)	**Year Ended December 31, 2017**
Beginning balance	$ *322*	$ *236*
Cost of warranty claims	*(5)*	*(37)*
Accruals for product warranties	*17*	*123*
Ending balance	$ *334*	$ *322*

NOTE *7* –COMMITMENTS

Lease Agreements

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 *$11,000* per month with a step-up of *3%* annually. Qualstar subleases a portion of the warehouse space to Interlink Electronics, Inc. ("Interlink") and is reimbursed for the space and other related expenses on a monthly basis. As described in Note *11,* Interlink is a related party.

Qualstar also leases approximately *5,400* square feet of office space in Westlake Village, California, that expires *January 31, 2020.* Rent on this facility is *$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 expires at the same time as the term of the master lease and the tenant pays Qualstar *$12,000* per month with a step-up of *3%* annually.

Effective *April 1, 2016,* a *two*-year lease was signed for *1,359* square feet for *$2,500* per month in Singapore, which has been renewed until *March 31, 2019.*

The Company provides for rent expense on a straight-line basis over the lease terms.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

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

Years Ending December 31,	Minimum Lease Payment	Sublease Revenue	Net Minimum Lease Payment
Remainder of 2018	$ *218*	$ *(110)*	$ *108*
2019	*274*	*(147)*	*127*
2020	*147*	*(12)*	*135*
2021	*23*	-	*23*
Total Commitment	$ *662*	$ *(269)*	$ *393*

Net rent expense for the *three* months ended *March 31, 2018* and *2017* was *$38,000* and *$36,000,* respectively.

NOTE *8* –STOCK INCENTIVE PLANS AND SHARE-BASED COMPENSATION

Share-Based Compensation

The Company did *not* incur an expense for share-based compensation associated with outstanding stock options for the *three* months ended *March 31, 2018* and *2017. No* income tax benefit was recognized in the condensed consolidated statements of operations for share-based arrangements in any period presented. At *March 31, 2018,* the Company did *not* have any unrecognized compensation costs related to share-based compensation.

Stock Option Plan

The Company has *two* share-based compensation 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.

The *2017* Stock Incentive Plan (the *"2017* Plan") was approved by Qualstar shareholders on *June 13, 2017.* 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 *200,000* 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 the 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.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

The following table summarizes stock option activity:

Options	Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2017	*188,033*	$ *7.38*	*8.63*	—
Granted	—	—	—	—
Exercised	*(5,500)*	*7.08*	—	—
Forfeited, canceled or expired	*(3,200)*	*14.28*	—	—
Outstanding at March 31, 2018	*179,333*	*7.26*	*8.45*	—
Exercisable at March 31, 2018	*179,333*	$ *7.38*	*8.45*	$ —

NOTE *9* – INCOME TAXES

We did *not* record a provision or benefit for income taxes for the *three* months ended *March 31, 2018* and *2017,* due to our prior year operating losses. The Company has recorded a full valuation allowance against its net deferred tax assets based on the Company's assessment regarding the realizable nature of these net deferred tax assets in future periods.

NOTE *10* – 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 U.S. 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* months ended *March 31, 2018* and *2017.* Our allocations of internal resources were made to the two business segments for the *three* months ended *March 31, 2018* and *2017.* 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 supply 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 (“OEMs”).

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.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

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

	Three Months Ended March 31,	
	2018	**2017**
	(unaudited)	(unaudited)
Revenue		
Power Supplies	$*1,315*	$ *1,691*
Storage:		
Product	*516*	*421*
Service	*1,104*	*327*
Total storage	$*1,620*	$ *748*
Revenue	$*2,935*	$ *2,439*

	Three Months Ended March 31,	
	2018	**2017**
	(unaudited)	(unaudited)
Income (loss) before Taxes		
Power Supplies	$*(56)*	$ *27*
Storage	*646*	*31*
Income (loss) before taxes	$*590*	$ *58*

	March 31, 2018 (unaudited)	**December 31, 2017**
Total Assets		
Power Supplies		
Cash and cash equivalents	$ *662*	$ *721*
Accounts receivable, net	*698*	*831*

Inventories, net	*753*	*725*
Property and equipment, net	*59*	*64*
Other assets	*45*	*8*
Total power supply assets	*2,217*	*2,349*
Storage		
Cash and cash equivalents	$ *4,569*	$ *3,977*
Restricted cash	*100*	*100*
Accounts receivable, net	*1,281*	*971*
Inventories, net	*858*	*839*
Prepaid expenses and other current assets	*163*	*163*
Property and equipment, net	*82*	*108*
Other assets	*32*	*60*
Total storage assets	*7,085*	*6,218*
Total Assets	$ *9,302*	$ *8,567*

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)-(Continued)

NOTE *11* – 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. ("Interlink"). Interlink reimburses Qualstar for leased space at the Simi Valley facility and for other administrative expenses paid by or on behalf of the Company. The total amount charged to Interlink for the *three* months ended *March 31, 2018* and *2017* was *$4,000* and *$2,000,* respectively. Interlink owed Qualstar *$1,000* and *$2,000* at *March 31, 2018* and *December 31, 2017,* respectively.

The Company reimburses Interlink for expenses paid on the Company's behalf. Interlink occasionally pays travel and other expenses incurred by Qualstar. The Company reimbursed Interlink *$57,000* and *$6,000* for the *three* months ended *March 31, 2018* and *2017,* respectively. Qualstar did *not* have a balance owed Interlink at *March 31, 2018.* At *December 31, 2017,* Qualstar owed Interlink *$17,000.*

NOTE *12* – SUBSEQUENT EVENTS

None

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Statements in this Quarterly Report on Form 10-Q concerning the future business, operating results and financial condition of the Company including estimates, projections, statements relating to our business plans, objectives and

operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements inherently are subject to risks and uncertainties, some of which we cannot predict or quantify. Our actual results may differ materially from the results projected in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in Part II, Item 1A of this report and in our Annual Report on Form 10-K for the year ended December 31, 2017 in “Item 1 Business,” “Item 1A Risk Factors,” and in “Item 7 Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Forward-looking statements are generally identified by the use of forward-looking terminology such as “believes,” “may,” “expects,” “intends,” “estimates,” “anticipates,” “plans,” “seeks,” or “continues,” or the negative thereof or variations thereon o similar terminology. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements to reflect the occurrence of events or circumstances in the future.

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 supply business unit is expanding 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 supply business is focusing on providing value add services in establishing itself as an optimized product development manufacturer (OPDM) 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 supply 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 supply industries.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

We describe our significant accounting policies in Note 1, “Summary of Significant Accounting Policies” of the accompanying Notes to Condensed Consolidated Financial Statements.

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 March 31,					
	2018			**2017**		
	$	%		**$**	%	
Power supply revenues	$1,315	44.8	%	$1,691	69.3	%
Storage revenues	1,620	55.2	%	748	30.7	%
Net revenues	2,935	100.0	%	2,439	100.0	%
Cost of goods sold	1,507	51.3	%	1,549	63.5	%
Gross profit	1,428	48.7	%	890	36.5	%
Operating expenses:						
Engineering	121	4.1	%	186	7.6	%
Sales and marketing	295	10.1	%	247	10.1	%
General and administrative	422	14.4	%	399	16.4	%
Total operating expenses	838	28.6	%	832	34.1	%
Income from operations	590	20.1	%	58	2.4	%

Other expense	-	-	%	-	-	%
Net income	$590	20.1	%	$58	2.4	%

Comparison of the Three Months Ended March 31, 2018 and 2017 (unaudited)

Change in Net Revenues:

	Three Months Ended March 31,							
	2018			2017			Change	
	Amount	% of net revenue		Amount	% of net revenue		Amount	%
Power supply revenues	$1,315	44.8	%	$1,691	69.3	%	$(376)	(22.2)%
Storage revenues	1,620	55.2	%	748	30.7	%	872	116.6%
Net revenues	$2,935	100.0	%	$2,439	100.0	%	$496	20.3 %

The increase in net revenues for the three months ended March 31, 2018 compared to the prior year period is attributable to the segment-specific factors described below.

Segment Revenue

Power Supplies – The decrease in power supply sales in the three months ended March 31, 2018 compared to the prior year period is primarily attributable to the current global electronic component shortage, which creates longer delivery times to fulfill our customer orders and accordingly reduced our revenue for the period. Additionally, key customers that incorporate our power supplies have variable production demands, which caused revenue fluctuations over the reporting period.

Storage – For the three months ended March 31, 2018 compared to the prior year period we experienced revenue growth from the sale of both products and services in our data storage segment. The increase in product revenues is attributed to new reseller relationships focused on media and entertainment, which resellers have a high demand for tape technology. Our service revenue increased compared to the prior year period, primarily due to the product development service revenue received from our recent partnership with Sony Imaging Products & Solutions Inc. for the development of an enterprise class optical disk archive (“ODA”) library and an increase in our technical support revenue.

Gross Profit:

	Three Months Ended March 31,							
	2018		2017		Change			
	Amount	% of net revenue		Amount	% of net revenue		Amount	%
Gross profit	$1,428	48.7	%	$890	36.5	%	$538	60.4%

The gross profit increase for the three months ended March 31, 2018 compared to the prior year period is primarily attributed to the increased service revenue offset with a reduction in power supply sales.

Operating Expenses:

	Three Months Ended March 31,								
	2018			2017			Change		
	Amount	% of net revenue		Amount	% of net revenue		Amount	%	
Engineering	$121	4.1	%	$186	7.6	%	$(65)	(34.9)%	
Sales and marketing	$295	10.1	%	$247	10.1	%	$48	19.4	%
General and administrative	$422	14.4	%	$399	16.4	%	$23	5.8	%

Engineering

Engineering expenses decreased in the three months ended March 31, 2018 from the prior year period as a result of a reduction in payroll and related expenses, and lower engineering materials and facilities costs.

Sales and Marketing

Sales and marketing expenses increased during the three months ended March 31, 2018 from the prior year period, primarily as a result of increased salaries and commission expenses.

General and Administrative

General and administrative costs increased during the three months ended March 31, 2018 from the prior year period. General and administrative costs increased primarily due to an increase in salaries, travel expenses, and consulting services, offset by a reduction in audit and legal fees.

Provision for Income Taxes: We did not record a provision or benefit for income taxes for each of the three months ended March 31, 2018 and 2017, due to our prior year operating losses. There were no changes to the valuation allowance during the three months ended March 31, 2018.

CONTRACTUAL OBLIGATIONS

The disclosures relating to our contractual obligations in our Annual Report on Form 10-K for the year ended December 31, 2017 has not materially changed since the report was filed.

OFF-BALANCE SHEET ARRANGEMENTS

As of the date of this Quarterly Report on Form 10-Q, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our 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

Operating Activities

Our principal source of liquidity is cash generated from operations. Net cash provided by operating activities was $499,000 for the three months ended March 31, 2018 compared to the net cash provided by operating activities of $51,000 for the three months ended March 31, 2017.

The cash provided by operating activities for the three months ended March 31, 2018 of $499,000 consisted of the operating income for the period of $590,000 and non-cash adjustments of $117,000, offset by changes in operating assets and liabilities of $208,000.

Investing Activities

Cash provided by investing activities was $34,000 for the three months ended March 31, 2018 relating to the exercise of stock options. For the three months ended March 31, 2017, cash used in investing activities was $2,000 for additional software upgrades.

Financing Activities

Cash was not provided by or used in financing activities during either the three months ended March 31, 2018 or 2017.

As of March 31, 2018, cash, restricted cash and cash equivalents increased $533,000 to $5,331,000 from $4,798,000 at December 31, 2017.

The Company’s efforts to control costs in prior periods are reflected in the positive cash flow in this quarter.

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.

ITEM 3. Qualitative and Quantitative Disclosures about Market Risk

Not applicable.

ITEM 4. Controls and Procedures

We maintain "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and our principal financial officer, as applicable, to allow timely decisions regarding required disclosure.

Evaluation of disclosure and controls and procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of disclosure controls and procedures. Based on the evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that our disclosure controls and procedures are operating in an effective manner to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in internal controls over financial reporting

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recent quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there is only reasonable assurance that our controls will succeed in achieving their stated goals under all potential future conditions.

PART II — OTHER INFORMATION

ITEM 1. Legal Proceedings

Qualstar is subject to a variety of claims and legal proceedings that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in the aggregate, will not have a material adverse impact on our financial statements, these matters are subject to inherent uncertainties and management's view of these matters may change in the future. We accrue loss contingencies in connection with our commitments and contingencies, including litigation, when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated.

ITEM 1A. Risk Factors

There have been no significant changes to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017.

ITEM 2. Unregistered Sales of Equity Securities 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

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File Number	Exhibit	Filing Date	
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
32.1	Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.					**
32.2	Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.					**
101.INS	XBRL Instance Document					X
101.SCH	XBRL Taxonomy Extension Schema Document					X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document					X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document					X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document					X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document					X

**Furnished herewith

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.

QUALSTAR CORPORATION

Dated: May 8, 2018 By: /s/STEVEN N. BRONSON
Steven. N. Bronson
Chief Executive Officer and President
(Principal Executive Officer)