Qualstar Corporation and Subsidiaries

Quarterly Report for the Six Months Ended June 30, 2020 and 2019

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QUALSTAR CORPORATION
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2020

INDEX

PART I — FINANCIAL INFORMATION

ITEM 1. Financial Statements

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

	June 30, 2020 (Unaudited)	December 31, 2019
Assets		
Current assets:		
Cash and cash equivalents	$ 4,781	$ 3,863
Restricted cash	100	100
Accounts receivables, net	923	2,366
Inventories, net	2,734	2,540
Prepaid expenses and other current assets	354	211
Total current assets	8,892	9,080
Non-current assets:		
Property and equipment, net	120	122
Right-of-use	544	676
Other assets	60	160
Total non-current assets	724	958
Total assets	$ 9,616	$ 10,038
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 746	$ 1,029
Accrued payroll and related liabilities	199	192
Deferred service revenue, short-term	602	702
Lease liabilities, current	225	252
Other liabilities	526	368
Total current liabilities	2,298	2,543
Long-term liabilities:		
Other long-term liabilities	40	52
Lease liabilities, long term	346	453
Deferred service revenue	246	247
Total long-term liabilities	632	752
Total liabilities	2,930	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 June 30, 2020 and December 31, 2019	18,848	18,848
Accumulated deficit	(12,162)	(12,105)
Total shareholders' equity	6,686	6,743
Total liabilities and shareholders' equity	$ 9,616	$ 10,038

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2020	**2019**	**2020**	**2019**
Net revenues	$ 1,908	$ 3,439	$ 3,962	$ 6,295
Cost of goods sold	1,143	2,634	2,527	4,570
Gross profit	765	805	1,435	1,725
Operating expenses:				
Engineering	108	228	179	351
Sales and marketing	271	306	614	614
General and administrative	288	298	708	651
Total operating expenses	667	832	1,501	1,616
Income (loss) from operations	98	(27)	(66)	109
Other income	1	16	9	21
Income (loss) before income taxes	99	(11)	(57)	130
Provision for income taxes	-	-	-	-
Net income (loss)	$ 99	$ (11)	$ (57)	$ 130
Earnings per share:				
Basic	$ 0.05	$ (0.01)	$ (0.03)	$ 0.07
Diluted	$ 0.05	$ (0.01)	$ (0.03)	$ 0.07
Shares used in per share calculation:				
Basic	1,925	1,952	1,925	1,972
Diluted	1,925	1,952	1,925	1,972

QUALSTAR CORPORATION
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(In thousands)

	Three Months Ended June 30, 2020				
	Common Stock		Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	Amount			
Balances at March 31, 2020	**1,925**	**$ 18,848**	**$ —**	**$ (12,261)**	**$ 6,587**
Stock repurchase		-	—	—	-
Net income (loss)	—	—	—	99	99
Balances at June 30, 2020	**1,925**	**$ 18,848**	**$ —**	**$ (12,162)**	**$ 6,686**

	Three Months Ended June 30, 2019				
	Common Stock		Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	Amount			
Balances at March 31, 2019	**1,971**	**$ 19,097**	**$ —**	**$ (11,957)**	**$ 7,140**
Exercise of stock options	(34)	(190)	—	—	(190)
Net income (loss)	—	—	—	(11)	(11)
Balances at June 30, 2019	**1,937**	**$ 18,907**	**$ —**	**$ (11,968)**	**$ 6,939**

	Six Months Ended June 30, 2020				
	Common Stock		Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	Amount			
Balances at December 31, 2019	**1,925**	**$ 18,848**	**$ —**	**$ (12,105)**	**$ 6,743**
Stock repurchase		-	—	-	-
Net income (loss)	—	—	—	(57)	(57)
Balances at June 30, 2020	**1,925**	**$ 18,848**	**$ —**	**$ (12,162)**	**$ 6,686**

	Six Months Ended June 30, 2019				
	Common Stock		Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	Amount			
Balances at December 31, 2018	**2,030**	**$ 19,426**	**$ —**	**$ (12,098)**	**$ 7,328**
Exercise of stock options	(93)	(519)	—	—	(519)
Net income	—	—	—	130	130
Balances at June 30, 2019	**1,937**	**$ 18,907**	**$ —**	**$ (11,968)**	**$ 6,939**

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

	Six months Ended June 30, 2020	Six months Ended June 30, 2019
Cash flows from operating activities:		
Net income (loss)	$ (57)	$ 130
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	25	24
Loss on disposal of assets	0	26
Provision for recovery of bad debts and returns, net	0	-
Provision for inventory obsolescence	44	137
Amortization of right of use	132	137
Changes in operating assets and liabilities:		
Accounts receivable	1,443	(429)
Inventories	(238)	16
Prepaid expenses and other current assets	(41)	39
Accounts payable	(284)	342
Accrued payroll and related liabilities	7	18
Deferred service revenue	(100)	(77)
Lease liabilities	(134)	(133)
Other accrued liabilities	(112)	(72)
Total adjustments	742	28
Net cash provided by operating activities	685	158
Cash flows from investing activities:		
Purchases of equipment	(24)	(44)
Net cash used in investing activities	(24)	(44)
Cash flows from financing activities:		
Purchases of common stock	-	(519)
Proceeds received from PPP Loan	257	
Net cash provided by (used in) financing activities	257	(519)
Net increase (decrease) in cash, restricted cash and cash equivalents	918	(405)
Cash, restricted cash and cash equivalents at beginning of period	3,963	4,881
Cash, restricted cash and cash equivalents at end of period	$ 4,881	$ 4,476
Supplemental cash flow disclosures:		
Income taxes paid	$ -	$ 10

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, 2019, 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.

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 (the "Annual Report"). There were no material changes to the significant accounting policies during the six months ended June 30, 2020.

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: Qualstar Corporation Singapore Private Limited, N2Power, Inc., 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.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

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.

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 June 30, 2020 we had deferred service revenue of approximately $848,000. 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 reported as of June 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.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

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.

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.

Note 2 – Recent Accounting Pronouncements

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.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

NOTE 3 - 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):

	June 30, 2020	December 31, 2019
	(unaudited)	
Raw materials	$ 268	$ 199
Finished goods	2,466	2,341
Net inventory balance	$ 2,734	$ 2,540

Property and equipment, net

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

	June 30, 2020	December 31, 2019
	(unaudited)	
Leasehold improvements	$ 78	$ 163
Furniture and fixtures	257	268
Machinery and equipment	367	609
	702	1,040
Less accumulated depreciation and amortization	(582)	(918)
Property and equipment, net	$ 120	$ 122

Depreciation and amortization expense for the six months ended June 30, 2020 and 2019 was $25,000 and $13,000 (unaudited), respectively.

Other Liabilities

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

	June 30, 2020	December 31, 2019
	(unaudited)	
Accrued warranty	$ 240	$ 290
Accrued outside commissions	23	55
Other liabilities	263	23
Total other accrued liabilities	$ 526	$ 368

QUALSTAR CORPORATION AND SUBSIDIARIES

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

NOTE 4 –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):

	Six Months Ended June 30, 2020	Year Ended December 31, 2019
	(unaudited)	
Beginning balance	$ 290	$ 365
Cost of warranty claims	(4)	(21)
Accruals for product warranties	(46)	(54)
Ending balance	$ 240	$ 290

NOTE 5 – 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 during the period. Diluted net income per share is computed by dividing net income 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 June 30,		Six Months Ended June 30,	
	2020	2019	2020	2019
In thousands (except per share amounts):				
Net income	$ 99	$ (11)	$ (57)	$ 130
Weighted average outstanding shares of common stock	1,925	1,952	1,925	1,972
Dilutive potential common shares from employee stock options	-	-	-	-
Common stock and common stock equivalents	1,925	1,952	1,925	1,972
Income per share:				
Basic net income per share	$ 0.05	$ (0.01)	$ (0.03)	$ 0.07
Diluted net income per share	$ 0.05	$ (0.01)	$ (0.03)	$ 0.07

For the three and six months ended June 30, 2020 and 2019, 155,633 and 178,000 outstanding stock options were excluded from the calculation of diluted net income per share as their inclusion would have been anti-dilutive.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

NOTE 6 –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 six months ended June 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 June 30, 2020, 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") 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:

Options	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	7.74	—
Granted	—	—	—	—
Exercised	—	—	—	—
Forfeited, canceled or expired	(5,700)	7.17	—	—
Outstanding at June 30, 2020	155,633	7.17	7.24	—
Exercisable at June 30, 2020	155,633	$ 7.17	7.24	$ —

NOTE 7 – INCOME TAXES

We did not record a provision or benefit for income taxes for the six months ended June 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.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

NOTE 8 – 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 June 30,				Six Months Ended June 30,			
	2020		2019		2020		2019	
Revenue – geographic activity (in thousands):	(unaudited)		(unaudited)		(unaudited)		(unaudited)	
	$	%	$	%	$	%	$	%
North America	$ 709	37.2 %	$ 2,231	64.9 %	$ 1,922	48.5 %	$ 3,917	62.2 %
Europe	601	31.5 %	234	6.8 %	975	24.6 %	777	12.3 %
Asia Pacific	359	18.8 %	950	27.6 %	814	20.5 %	1,559	24.8 %
Other	239	12.5 %	24	0.7 %	251	6.4 %	42	0.7 %
	$ 1,908	100.0 %	$ 3,439	100.0 %	$ 3,962	100.0 %	$ 6,295	100.0 %

Two customers accounted for 11.3% and 7.6% of the Company's net revenue for the three-month period ended June 30, 2020. At June 30, 2019, the same two customers were 0% of the company's revenue. The accounts receivable balances totaled 0% of the revenue for the same two customers as of December 31, 2019.

Two customers accounted for 6.0% and 5.5% of the Company's net revenue for the six-month period ended June 30, 2020. At June 30, 2019, the same two customers were 15.2% and 0% of the company's net revenue.

NOTE 9 – COMMITMENTS

Lease Agreements

The Company entered into a lease in Camarillo, California for its corporate headquarters 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") and is reimbursed for the space and other related expenses on a monthly basis. As described in Note 12, Interlink and BKF are related parties.

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 Standard Sublease Multi-Tenant (the "Sublease"), with Stillwater Agency, Inc., a California corporation ("Stillwater"), for the Simi Valley location, which previously served as Qualstar's corporate headquarters location and principal executive office. The term of the Sublease commenced on July 15, 2019 and ends on February 28, 2021 (the "Term"). The base rent under the Sublease is approximately $12,886 per month. Stillwater is also responsible for approximately nine percent (9%) 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 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 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.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

Effective April 1, 2016, the Company leased 1,359 square feet of office space for $2,500 per month in Singapore, 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 was 4.33% during the six months ended June 30, 2020, 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 June 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 June 30, 2020, the Company had current and long-term operating lease liabilities of $225,000 and $346,000, respectively, and right of use assets of $544,000.

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 2020	$ 130	$ (77)	$ 53
2021	148	(26)	122
2022	129	-	129
2023	133	-	133
2024	79	-	79
After		-	-
Total undiscounted future non-cancelable minimum lease payments	619	(103)	516
Less: Imputed interest	(54)	-	(54)
Present value of lease liabilities	$ 565	$	$ 462

Net rent expense for the six months ended June 30, 2020 and 2019 was $33,000 and $37,000, respectively.

Other information related to our operating leases is as follows:

	Six Months Ended June 30, 2020
Weighted average remaining lease term in years	1.19
Weighted average discount rate	4.33%
Cash paid for amounts included in the measurement of lease liabilities:	
Operating cash flows from operating leases	$ 83
Operating cash flows from finance leases	-
Financing cash flows from finance leases	-

QUALSTAR CORPORATION AND SUBSIDIARIES

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

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 and six months ended June 30, 2020 and 2019. Our allocations of internal resources were made to the two business segments for the three and six months ended June 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 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.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2020	**2019**	**2020**	**2019**
Revenue				
Power Supplies	$ 643	$ 1,297	$ 1,398	$ 2,667
Storage:				
Product	1,160	1,129	1,900	1,912
Service	105	1,013	664	1,716
Total storage	$ 1,265	$ 2,142	$ 2,564	$ 3,628
Revenue	$ 1,908	$ 3,439	$ 3,962	$ 6,295

	Three Months Ended June 30,		Six Months Ended June 30,	
	2020	**2019**	**2020**	**2019**
Income (Loss) before Taxes				
Power Supplies	$ (142)	$ (346)	$ (353)	$ (356)
Storage	241	335	296	486
Income (loss) before taxes	$ 99	$ (11)	$ -57	$ 130

QUALSTAR CORPORATION AND SUBSIDIARIES

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

Total Assets	**June 30, 2020** (unaudited)	**December 31, 2019**
Power Supplies		
Cash and cash equivalents	$ 625	$ 527
Accounts receivable, net	462	840
Inventories, net	1,247	872
Property and equipment, net	3	11
Other assets	(2,232)	107
Total power supply assets	105	2,357
Storage		
Cash and cash equivalents	$ 4,156	$ 3,336
Restricted cash	100	100
Accounts receivable, net	461	1,526
Inventories, net	1,487	1,668
Prepaid expenses and other current assets	213	111
Property and equipment, net	116	676
Other assets	2,978	264
Total storage assets	9,511	7,681
Total Assets	$ 9,616	$ 10,038

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") and BKF Capital Group, Inc. ("BKF"). 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 Qualstar are as follows.

	Three months ended June 30,			
	2020		**2019**	
	Due to Interlink	**Due from Interlink**	**Due to Interlink**	**Due from Interlink**
		(in thousands)		
Balance at March 31,	$ 1	$ 7	$ 35	$ 2
Billed by Interlink	126	—	60	—
Paid to Interlink	(79)	—	(94)	—
Billed to Interlink	—	20	—	4
Paid by Interlink	—	(20)	—	(5)
Balance at June 30,	$ 48	$ 7	$ 1	$ 1

QUALSTAR CORPORATION AND SUBSIDIARIES

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

	Six months ended June 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 by Interlink	254	—	114	—
Paid to Interlink	(230)	—	(116)	—
Billed to Interlink	—	53	—	10
Paid by Interlink	—	(58)	—	(11)
Balance at June 30,	$ 48	$ 7	$ 1	$ 1

The company occasionally reimburses BKF for expenses paid on the company's behalf. All related party transactions between Qualstar and BKF are immaterial.

NOTE 12 – SUBSEQUENT EVENTS

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, distributers, 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.

Irvine, CA Facility

Interlink and BKF entered into an oral agreement with us for our corporate headquarters in Irvine, CA in June 2020, pursuant to which Interlink and BKF share with us all rent and lease-related costs starting July 1, 2020 as follows: 47.5% for Interlink, 47.5% for Qualstar, and 5% for BKF.

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

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 June 30,				Six Months Ended June 30,			
	2020		2019		2020		2019	
	$	%	$	%	$	%	$	%
Power supply revenues	$ 643	33.7 %	$ 1,297	37.7 %	$ 1,398	35.3 %	$ 2,667	42.4 %
Storage revenues	1,265	66.3 %	2,142	62.3 %	2,564	64.7 %	3,628	57.6 %
Net revenues	1,908	100.0 %	3,439	100.0 %	3,962	100.0 %	6,295	100.0 %
Cost of goods sold	1,143	59.9 %	2,634	76.6 %	2,527	63.8 %	4,570	72.6 %
Gross profit	765	40.1 %	805	23.4 %	1,435	36.2 %	1,725	27.4 %
Operating expenses:								
Engineering	108	5.7 %	228	6.6 %	179	4.5 %	351	5.6 %
Sales and marketing	271	14.2 %	306	8.9 %	614	15.5 %	614	9.8 %
General and administrative	288	15.1 %	298	8.7 %	708	17.9 %	651	10.3 %
Total operating expenses	667	35.0 %	832	24.2 %	1,501	37.9 %	1,616	25.7 %
Income from operations	98	5.1 %	(27)	(0.8)%	(66)	(1.7) %	109	1.7 %
Other income	1	0 %	16	0.5 %	9	0.2 %	21	0.3 %
Net income	$ 99	5.1 %	$ (11)	(0.3) %	$ (57)	(1.5) %	$ 130	2.0 %

Change in Net Revenues:

Comparison of the Three months Ended June 30, 2020 and 2019 (Unaudited)

	Three months Ended June 30,				Change	
	2020		2019			
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Power supply revenues	$ 643	33.7 %	$ 1,297	37.7 %	$ (654)	(50.4) %
Storage revenues	1,265	66.3 %	2,142	62.3 %	(877)	(40.9) %
Net revenues	$ 1,908	100.0 %	$ 3,439	100.0 %	$ (1,531)	(44.5) %

Comparison of the Six months Ended June 30, 2020 and 2019 (Unaudited)

	Six months Ended June 30,				Change	
	2020		2019			
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Power supply revenues	$ 1,398	35.3 %	$ 2,667	42.4 %	$ (1,269)	(47.6) %
Storage revenues	2,564	64.7 %	3,628	57.6 %	(1,064)	(29.3) %
Net revenues	$ 3,962	100.0 %	$ 6,295	100.0 %	$ (2,333)	(37.1) %

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

Segment Revenue

Power Supplies – The decrease in power supply sales in the six months ended June 30, 2020 compared to the prior year period is primarily attributable to the COVID-19 pandemic. In the first quarter, the extended Chinese New Year halted production with our contract manufacturer in China. In the second quarter, as China went back into production, many of our customers in the United States and abroad were shut down. For the three months ended June 30, 2020, 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 six months ended June 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 ("ODA") library, also with the decline in technical support revenue. For the three months ended June 30, 2020, we are still facing the weak market worldwide as a result of COVID-19.

Gross Profit:

Comparison of the Three months Ended June 30, 2020 and 2019 (Unaudited)

	Three months Ended June 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Gross profit	$ 765	40.1 %	$ 805	23.4 %	$ (40)	(5.0) %

Comparison of the Six months Ended June 30, 2020 and 2019 (Unaudited)

	Six months Ended June 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Gross profit	$ 1,435	36.2 %	$ 1,725	27.4 %	$ (290)	(16.8) %

The gross profit decrease for the three and six months ended June 30, 2020 compared to the prior year period is primarily attributed to our power supply business. The reduced revenue did not contribute the same margins to apply to the fixed costs of the business as in the prior year.

Operating Expenses:

Comparison of the Three months Ended June 30, 2020 and 2019 (Unaudited)

	Three months Ended June 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Engineering	$ 108	5.7 %	$ 228	6.6 %	$ (120)	(52.6) %
Sales and marketing	$ 271	14.3 %	$ 306	8.9 %	$ (35)	(11.4) %
General and administrative	$ 288	15.0 %	$ 298	8.7 %	$ (10)	(3.4) %

Comparison of the Six months Ended June 30, 2020 and 2019 (Unaudited)

	Six months Ended June 30,					
	2020		2019		Change	
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Engineering	$ 179	4.5 %	$ 351	5.6 %	$ (172)	(49) %
Sales and marketing	$ 614	15.5 %	$ 614	9.8 %	$ 0	0 %
General and administrative	$ 708	17.9 %	$ 651	10.3 %	$ 57	8.8 %

Engineering

Engineering expenses decreased for the three and six months ended June 30, 2020 compared to the prior year, primarily due to the reduction in payroll and related expenses as there was an employee reduction.

Sales and Marketing

Sales and marketing expenses only changed slightly for the three months ended June 30, 2020 due to the weak market as a result of COVID-19 compared to the same period last year. Sales and marketing expense is the same during the six months ended June 30, 2020 from the prior year period.

General and Administrative

General and administrative costs decreased during the three months ended June 30, 2020 from the prior year period due to more efficient management. General and administrative costs increased slightly during the six months ended June 30, 2020 from the prior year period as a result of an increase in temporary labor costs, audit and legal fees in the first quarter of 2020.

Other income

Other income decreased as a result of less interest earned during the three and six months ended June 30, 2020.

Provision for Income Taxes

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

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2020, cash, restricted cash and cash equivalents increased $504,000 to $4881,000 from $4,377,000 at March 31, 2020. And cash, restricted cash and cash equivalents balance at June 30, 2020 increased $918,000 to $4,881,000 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 $685,000 for the six months ended June 30, 2020 compared to the net cash provided by operating activities of $158,000 for the six months ended June 30, 2019. Net cash provided by operating activities was $247,000 for the three months ended June 30, 2020 compared to the net cash spending of $55,000 for the operating activities for the three months ended June 30, 2019.

The cash provided by operating activities for the three months ended June 30, 2020 of $247,000 consisted an increase of non-cash adjustments of $67,000 and an increase in the changes of operating assets and liabilities of $81,000 in addition to the operating income for the period of $99,000. The cash provided by operating activities for the six months ended June 30, 2020 of $685,000 consisted an increase of non-cash adjustments of $201,000 and an increase in the changes of operating assets and liabilities of $542,000 offset by the operating loss for the period of $57,000. The cash provided by the change in operating assets and liabilities was primarily due to the reductions of accounts receivable for both the three and six months ended June 30, 2020.

Investing Activities

Cash used for investing activities for the six months ended June 30, 2020 was $24,000 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 June 30, 2020

Financing Activities

Cash provided by financing activities for the six months ended June 30, 2020 was from a loan in the amount of $257,000 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 $257,000 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.