Qualstar Corporation and Subsidiaries

Quarterly Report
For the Periods Ended June 30, 2022 and 2021

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QUALSTAR CORPORATION AND SUBSIDIARIES

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

	June 30, 2022	December 31, 2021
Assets		
Current assets:		
Cash and cash equivalents	$ 2,972	$ 4,095
Restricted cash	100	100
Accounts receivable, net	1,093	1,354
Inventories	3,067	2,276
Prepaid expenses and other current assets	184	304
Total current assets	7,416	8,129
Property and equipment, net	101	124
Right-of-use assets	318	300
Deferred tax assets	30	30
Other assets	21	24
Total assets	$ 7,886	$ 8,607
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 622	$ 977
Accrued payroll and related liabilities	140	188
Deferred service revenue	616	622
Lease liabilities, current	158	117
Other accrued liabilities	177	168
Total current liabilities	1,713	2,072
Long-term liabilities:		
Lease liabilities, long-term	180	204
Deferred service revenue, long-term	459	447
Other long-term liabilities	28	28
Total long-term liabilities	667	679
Total liabilities	2,380	2,751
Commitments and contingencies (Note 7)		
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; 1,884,033 shares issued and outstanding at both June 30, 2022 and December 31, 2021	18,789	18,789
Accumulated deficit	(13,283)	(12,933)
Total shareholders' equity	5,506	5,856
Total liabilities and shareholders' equity	$ 7,886	$ 8,607

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended June 30, 2022	Three Months Ended June 30, 2021	Six Months Ended June 30, 2022	Six Months Ended June 30, 2021
Revenues	$ 1,863	$ 2,929	$ 4,273	$ 4,626
Cost of goods sold	1,382	1,847	3,069	3,098
Gross profit	481	1,082	1,204	1,528
Operating expenses:				
Engineering	118	87	168	261
Sales and marketing	336	359	659	764
General and administrative	348	74	660	362
Total operating expenses	802	520	1,487	1,387
Income (loss) from operations	(321)	562	(283)	141
Other income (expense), net	(68)	2	(67)	1
Income (loss) before income taxes	(389)	564	(350)	142
Provision for income taxes	-	-	-	-
Net income (loss)	$ (389)	$ 564	$ (350)	$ 142
Earnings (loss) per share:				
Basic and diluted	$ (0.21)	$ 0.29	$ (0.19)	$ 0.07
Weighted average common shares outstanding:				
Basic and diluted	1,884	1,953	1,884	1,953

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands)
(unaudited)

	Common Stock				Accumulated		
Three Months Ended June 30, 2022	**Shares**		**Amount**		**Deficit**		**Total**
Balances at April 1, 2022	1,884	$	18,789	$	(12,894)	$	5,895
Net (loss)	-		-		(389)		(389)
Balances at June 30, 2022	1,884	$	18,789	$	(13,283)	$	5,506

	Common Stock				Accumulated		
Six Months Ended June 30, 2022	**Shares**		**Amount**		**Deficit**		**Total**
Balances at January 1, 2022	1,884	$	18,789	$	(12,933)	$	5,856
Net (loss)	-		-		(350)		(350)
Balances at June 30, 2022	1,884	$	18,789	$	(13,283)	$	5,506

	Common Stock				Accumulated		
Three Months Ended June 30, 2021	**Shares**		**Amount**		**Deficit**		**Total**
Balances at April 1, 2021	1,953	$	18,990	$	(13,785)	$	5,205
Net income	-		-		564		564
Balances at June 30, 2021	1,953	$	18,990	$	(13,221)	$	5,769

	Common Stock				Accumulated		
Six Months Ended June 30, 2021	**Shares**		**Amount**		**Deficit**		**Total**
Balances at January 1, 2021	1,950	$	18,980	$	(13,363)	$	5,617
Share repurchases	3		10		-		10
Net income	-		-		142		142
Balances at June 30, 2021	1,953	$	18,990	$	(13,221)	$	5,769

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30, 2022	Six Months Ended June 30, 2021
Cash flows from operating activities:		
Net income (loss)	$ (350)	$ 142
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	23	16
Share-based compensation	-	10
Adjustment to reconcile operating lease expense to cash paid	(1)	(2)
Gain on forgiveness of PPP loan	-	(258)
Changes in operating assets and liabilities:		
Accounts receivable	261	339
Inventories	(791)	41
Prepaid expenses and other assets	122	39
Accounts payable	(355)	531
Accrued payroll and related liabilities	(48)	(88)
Deferred service revenue	7	(70)
Other liabilities	9	39
Net cash provided by (used in) operating activities	(1,123)	739
Cash flows from investing activities:		
Purchases of property and equipment	-	(38)
Net cash used in investing activities	-	(38)
Cash flows from financing activities:		
Proceeds received from PPP loan	-	263
Net cash provided by financing activities	-	263
Net increase (decrease) in cash, cash equivalents, and restricted cash	(1,123)	964
Cash, cash equivalents, and restricted cash at beginning of period	4,195	4,257
Cash, cash equivalents, and restricted cash at end of period	$ 3,072	$ 5,221
Reconciliation of cash, cash equivalents and restricted cash, end of period:		
Cash and cash equivalents, end of period	$ 2,972	$ 5,121
Restricted cash, end of period	100	100
Cash, cash equivalents and restricted cash, end of period	$ 3,072	$ 5,221
Supplemental disclosure of cash flow information:		
Income taxes paid	$ 3	$ 9
Interest paid	$ -	$ -
Supplemental non-cash investing and financing activities:		
Lease liabilities arising from obtaining right-of-use assets	$ 77	$ -

Note 1 – The Company and its Significant Accounting Policies

Business

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 systems are marketed under the Qualstar brand and 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 medical.

Qualstar Corporation was incorporated in California in 1984 and currently has three wholly owned subsidiaries. The N2Power, Inc. subsidiary (N2Power) operates the Company's power supplies business. The Q-Smart Data Limited (China) subsidiary pursues new data storage business opportunities in Asia. The Qualstar Limited (U.K.) subsidiary expands the Company's data storage business in Europe and Africa. The Company's former Qualstar Corporation Singapore Private Limited subsidiary previously gave the Company an engineering footprint in Singapore, and the Company's former Q-Smart Data Private Limited (Singapore) subsidiary previously pursued new business opportunities in Asia, both of which were dissolved in March 2022.

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

Principles of Consolidation

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

Estimates and Assumptions

Preparing financial statements in accordance with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, 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.

Public Health Threats

Public health threats could adversely affect our ongoing or planned business operations. For example, the COVID-19 pandemic resulted in quarantines, restrictions on travel and other business and economic disruptions. We cannot predict the scope and severity of any potential business shutdowns or disruptions from such public health threats, but if we or any of the third parties with whom we engage, including the suppliers, distributers, resellers and other third parties with whom we conduct business, were to experience shutdowns or other business disruptions, our ability to conduct our business in the manner and on the timelines we plan could be materially and adversely impacted.

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, 2022, we had deferred service revenue of approximately $1,075,000. At December 31, 2021, we had deferred service revenue of approximately $1,069,000.

Cash and Cash Equivalents

Qualstar classifies as cash equivalents only cash and those investments that are highly liquid, interest-earning investments with original maturities of three months or less from the date of purchase.

Restricted Cash

At June 30, 2022 and December 31, 2021, $100,000 in cash was restricted for use as collateral for the Company's credit cards.

Allowance for Doubtful Accounts

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. We determine the allowance based on known troubled accounts, historical experience, and other currently available evidence.

Inventories

Inventories are stated at the lower of cost (first in, first out basis) or net realizable value. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. We regularly review inventory quantities on hand, future purchase commitments with our suppliers, and the estimated utility of our inventory. If our review indicates a reduction in utility below carrying value, we reduce our inventory to a new cost basis.

Property and Equipment, net

Property and equipment are recorded at cost less accumulated depreciation and amortization. Depreciation expense is computed using the straight-line method. Leasehold improvements are amortized over the shorter of the estimated useful life of the asset or the term of the lease. Estimated useful lives are as follows:

Machinery and equipment	5-7 years
Furniture and fixtures	5-7 years
Computer equipment	3-5 years
Leasehold improvements	3-5 years

Expenditures for normal maintenance and repairs are charged to expense as incurred, and improvements are capitalized. Upon the sale or retirement of property or equipment, the asset cost and related accumulated depreciation are removed from the respective accounts and any gain or loss is included in the results of operations.

Long-Lived Assets

Qualstar evaluates long-lived assets for potential impairment whenever events or changes in circumstances indicate the carrying amount of any asset may not be recoverable. An impairment loss would be recognized when the estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition is less than the carrying amount. If impairment is indicated, the amount of the loss to be recorded is based upon an estimate of the difference between the carrying amount and the fair value of the asset. Fair value is based upon discounted cash flows expected to result from the use of the asset and its eventual disposition and other valuation methods. No impairment losses of long-lived assets were recognized during the periods presented.

Warranty Obligations

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

We provide a three-year 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 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.

Shipping and Handling Costs

Qualstar records all customer charges for outbound shipping and handling to freight revenue. All inbound and outbound shipping and fulfillment costs are classified as costs of goods sold.

Engineering

All engineering costs are charged to expense as incurred. These costs consist primarily of engineering salaries, benefits, outside consultant fees, purchased parts and supplies directly involved in the design and development of new products, facilities and other internal costs.

Advertising

Advertising and promotion expenses include costs associated with direct and indirect marketing, trade shows and public relations. Qualstar expenses all costs of advertising and promotion as incurred.

Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, which include cash equivalents, accounts receivable, and accounts payable, approximate their fair values.

Share-Based Compensation

Share-based compensation cost is measured at the grant date based on fair value of the award and is recognized as expense over the applicable vesting period of the stock award using the straight-line method.

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 carryforwards. 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.

The Company did not record an income tax provision or benefit for the three-month or six-month periods ended June 30, 2022 and 2021, as the Company has net operating loss carryforwards available to offset taxable income.

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 as an accounting policy election and recognizes rent expense on a straight-line basis over the lease term.

Operating Segments

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

Recent Accounting Guidance Not Yet Adopted

We reviewed all recently issued, but not yet effective, accounting pronouncements and concluded none are expected to be applicable or material to our consolidated financial statements.

Subsequent Events

The Company has evaluated subsequent events through August 12, 2022, being the date these condensed consolidated financial statements were issued.

Note 2 – Balance Sheet Details

The following tables provide details of selected balance sheet accounts:

	June 30, 2022	December 31, 2021
Inventories	(In thousands)	
Raw materials	$ 130	$ 164
Finished goods	2,937	2,112
Net inventory balance	$ 3,067	$ 2,276

	June 30, 2022	December 31, 2021
Property and equipment, net	(In thousands)	
Machinery and equipment	$ 381	$ 382
Furniture and fixtures, and computer equipment	258	258
Leasehold improvements	118	119
	757	759
Less accumulated depreciation and amortization	(656)	(635)
Property and equipment, net	$ 101	$ 124

Depreciation and amortization expense for the three months ended June 30, 2022 and 2021 was $11,000 and $8,000, respectively. Depreciation and amortization expense for the six months ended June 30, 2022 and 2021 was $23,000 and $16,000, respectively.

Accrued payroll and related liabilities	June 30, 2022	December 31, 2021
	(In thousands)	
Accrued salaries, wages, and payroll taxes	$ 31	$ 82
Accrued vacation	109	106
Total accrued payroll and related liabilities	$ 140	$ 188

Other accrued liabilities	June 30, 2022	December 31, 2021
	(In thousands)	
Accrued warranty	$ 154	$ 142
Accrued outside commissions	23	26
Total other accrued liabilities	$ 177	$ 168

Note 3 – Shareholders' Equity

In September 2021, the board of directors approved a stock repurchase program (the "Stock Repurchase Program") to repurchase shares of the Company's common stock. The Stock Repurchase Program permits the Company to repurchase up to a maximum of 500,000 shares of common stock at an aggregate purchase price of up to $1,500,000. Under the Stock Repurchase Program, during the three months and six months periods ended June 30, 2022, the Company did not repurchase any shares. During the period from September 1, 2021 through June 30, 2022, the Company has repurchased 69,326 shares for an aggregate purchase price of $201,000.

Note 4 – Earnings Per Share

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2022	2021	2022	2021
Net income (loss)	$ (389)	$ 564	$ (350)	$ 142
Weighted average outstanding shares of common stock - basic	1,884	1,953	1,884	1,953
Dilutive potential common shares from employee stock options	-	-	-	-
Weighted average outstanding shares of common stock - diluted	1,884	1,953	1,884	1,953
Earnings (loss) per share:				
Basic earnings (loss) per share	$ (0.21)	$ 0.29	$ (0.19)	$ 0.07
Diluted earnings (loss) per share	$ (0.21)	$ 0.29	$ (0.19)	$ 0.07

For the three months ended June 30, 2022 and 2021, 126,300 and 126,300 outstanding stock options, respectively, were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive. For the six months ended June 30, 2022 and 2021, 126,300 and 140,633 outstanding stock options, respectively, were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive.

Note 5 – Share-Based Compensation and Stock Incentive Plan

Share-Based Compensation

The Company did not incur share-based compensation expense associated with share-based compensation awards for the three-month or six-month periods ended June 30, 2022, or the three-month period ended June 30, 2021. The share-based compensation recorded during the six-month period ended June 30, 2021 was for shares of common stock issued to certain members of the Board of Directors as compensation for services in accordance with the Company's Outside Director Compensation Policy. No income tax benefit was recognized in the condensed consolidated statements of operations for share-based arrangements in any period presented. At June 30, 2022, the Company did not have any unrecognized compensation costs related to share-based compensation.

Stock Incentive Plan

The Company's 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, of which 183,700 shares remain available for issuance as of June 30, 2022. The 2017 Plan is administered by the Company's Board of Directors.

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

The following table summarizes stock option activity:

	Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2021	126,300	$ 7.08	5.59	$ -
Granted	-			
Exercised	-			
Forfeited, canceled or expired	(10,000)	7.08		
Outstanding at June 30, 2022	116,300	7.08	5.10	-
Exercisable at June 30, 2022	116,300	$ 7.08	5.10	$ -

Note 6 – Concentration of Credit Risk, Significant Customers, and Geographic Information

We have no auction rate securities or derivative financial instruments in our investment portfolio. Cash and other investments may be in excess of FDIC insurance limits.

One customer accounted for more than 10% of the Company's revenue for the three-month period ended June 30, 2022. A different customer accounted for more than 10% of the Company's revenue for the three-month period ended June 30, 2021. Two customers each accounted for more than 10% of the Company's revenue for the six-month period ended June 30, 2022. A different customer accounted for more than 10% of the Company's revenue for the six-month period ended June 30, 2021.

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.

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2022		2021		2022		2021	
North America	$ 1,393	74.8 %	$ 2,266	77.4 %	$ 3,182	74.5 %	$ 3,622	78.3 %
Europe	349	18.7	458	15.6	723	16.9	650	14.1
Asia Pacific	103	5.5	197	6.7	299	7.0	323	7.0
Other	18	1.0	8	0.3	69	1.6	31	0.7
	$ 1,863	100.0 %	$ 2,929	100.0 %	$ 4,273	100.0 %	$ 4,626	100.0 %

The primary suppliers of our data storage products are located in California and Germany. The primary suppliers of our power supplies products are located in China and Taiwan. If a manufacturer should be unable to deliver products to us in a timely basis or at all, our data storage or power supplies businesses could be adversely affected. Though we have many years of favorable experience with these suppliers, there can be no assurance that circumstances might not change and compel a supplier to curtail or terminate deliveries to us.

Note 7 – Commitments and Contingencies

Lease Agreements

The Company leases a 9,910 square-foot facility in Camarillo, California. The term of the lease is 5 years and two months, expiring July 31, 2024. The rent on this facility is $9,910 per month with a 3% step-up annually. Qualstar permits Interlink Electronics, Inc. (“Interlink”) to use a portion of the facility and is reimbursed for the space and other related expenses on a monthly basis. As described in Note 9, Interlink is a related party.

The Company uses a portion of Interlink’s Irvine, California office as its corporate headquarters, pursuant to which the Company pays a facility usage fee of approximately $4,600 per month. The Company also uses a portion of Interlink’s Los Angeles, California office, pursuant to which the Company pays a facility usage fee of approximately $600 per month.

The Company leases a 7,287 square foot facility in Shenzhen, China. In May 2022, we renewed this lease for the period June 1, 2022 through May 31, 2024 for approximately $3,500 per month.

The Company’s 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; 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 as of January 1, 2019 was 4.33%. No new ROU assets were capitalized during the six-month period ended June 30, 2021. The weighted average incremental borrowing rate used to determine the initial value of ROU assets and lease liabilities during the six-month period ended June 30, 2022 was 5.00%. Certain of our contracts for real estate may contain both 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, 2022, 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, 2022, the Company had current and long-term operating lease liabilities of $158,000 and $180,000, respectively, and right-of-use assets of $318,000.

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

	Minimum Lease Payment
2022 (remainder of year)	$ 85
2023	174
2024	96
Total undiscounted future non-cancelable minimum lease payments	355
Less: Imputed interest	(17)
Present value of lease liabilities	$ 338

During the three months ended June 30, 2022 and 2021, the Company incurred approximately $44,000 and $43,000, respectively, of operating lease costs, which are included in operating expenses in our condensed consolidated statements of operations. During the six months ended June 30, 2022 and 2021, the Company incurred approximately $88,000 and $80,000, respectively, of operating lease costs, which are included in operating expenses in our condensed consolidated statements of operations.

Legal and Other Contingencies

The Company 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 consolidated financial statements, these matters are subject to inherent uncertainties and management's view of these matters may change in the future. 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 consolidated financial statements. No loss contingency was recorded as of June 30, 2022.

Note 8 – Segment Information

In its operation of the business, management reviews certain financial information, including segmented internal profit and loss statements prepared on a basis consistent with GAAP. Our two segments are Data Storage and Power Supplies. 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, 2022 and 2021. The types of products and services provided by each segment are summarized below:

Data Storage — We manufacture and market data storage systems, including highly scalable automated magnetic tape libraries used to store, retrieve and manage electronic data. Our tape-based storage solutions enable businesses to manage the massive growth of digital data assets in a cost-effective manner, and 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 data-rich and video-centric markets such as media and entertainment, oil and gas, surveillance, digital security and medical imaging to achieve targeted data workflows.

Power Supplies — We design and market high-efficiency switching power supplies. 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 utilize contract manufacturers in Asia to produce our power supplies products. We sell our products globally through authorized resellers and directly to original equipment manufacturers.

Segment revenues, income (loss) before taxes, and total assets were as follows:

	Three Months Ended June 30, 2022	Three Months Ended June 30, 2021	Six Months Ended June 30, 2022	Six Months Ended June 30, 2021
	(In thousands)			
Revenues				
Data Storage:				
Product	$ 912	$ 1,445	$ 2,231	$ 2,125
Service	297	321	557	609
Total Data Storage	1,209	1,766	2,788	2,734
Power Supplies	654	1,163	1,485	1,892
Revenues	$ 1,863	$ 2,929	$ 4,273	$ 4,626

	Three Months Ended June 30, 2022	Three Months Ended June 30, 2021	Six Months Ended June 30, 2022	Six Months Ended June 30, 2021
	(In thousands)			
Income (Loss) Before Taxes				
Data Storage	$ (132)	$ 367	$ (25)	$ 219
Power Supplies	(257)	197	(325)	(77)
Income (loss) before taxes	$ (389)	$ 564	$ (350)	$ 142

	June 30, 2022	December 31, 2021
	(In thousands)	
Total Assets		
Data Storage		
Cash and cash equivalents	$ 2,242	$ 3,474
Restricted cash	100	100
Accounts receivable, net	555	804
Inventories	2,785	1,936
Prepaid expenses and other current assets	59	185
Property and equipment, net	101	123
Right-of-use assets	318	300
Other assets	51	54
Total Data Storage assets	6,211	6,976
Power Supplies		
Cash and cash equivalents	730	621
Accounts receivable, net	538	550
Inventories	282	340
Prepaid expenses and other current assets	125	119
Property and equipment, net	-	1
Total Power Supplies assets	1,675	1,631
Total Assets	$ 7,886	$ 8,607

Note 9 – Related Party Transactions

Interlink Electronics, Inc.

Interlink Electronics, Inc. (NASDAQ: LINK) ("Interlink") is a related party. Steven N. Bronson, our President and Chief Executive Officer and Director, is also Chairman of the Board, President and Chief Executive Officer of Interlink. Ryan J. Hoffman, our Chief Financial Officer, is also the Chief Financial Officer of Interlink. Mr. Bronson, together with BKF Capital Group, Inc. (OTCMKTS: BKFG) which he controls, has a controlling interest in both Qualstar and Interlink. We have a facilities agreement with Interlink to allow Interlink to use of a portion of our Camarillo, California office and warehouse facility, for which we have agreed to split substantially all rent and facilities-related costs on an apportioned basis according to the approximate relative usage levels by each entity. We also have a facilities agreement with Interlink to allow us to use of a portion of Interlink's Irvine, California and Los Angeles California office facilities, for which we have agreed to split substantially all rent and facilities-related costs on an apportioned basis according to the approximate relative usage levels by each entity. In addition, we have consulting agreements with Interlink for certain of our respective employees and/or independent contractors that provide certain operational, sales, marketing, general and administrative services to the other entity. Qualstar and Interlink also agree to reimburse, or be reimbursed by, one another for expenses paid by one company on behalf of the other. Transactions with Interlink are as follows:

	Three Months Ended June 30,			
	2022		2021	
	Due to Interlink	Due from Interlink	Due to Interlink	Due from Interlink
	(in thousands)			
Balance at April 1,	$ 19	$ 8	$ 115	$ 1
Billed (or accrued) to Interlink by Qualstar	-	22	-	30
Paid by Interlink to Qualstar	-	(23)	-	(30)
Billed (or accrued) to Qualstar by Interlink	200	-	266	-
Paid by Qualstar to Interlink	(196)	-	(365)	-
Balance at June 30,	$ 23	$ 7	$ 16	$ 1

	Six Months Ended June 30,			
	2022		2021	
	Due to Interlink	Due from Interlink	Due to Interlink	Due from Interlink
	(in thousands)			
Balance at January 1,	$ 85	$ 8	$ 52	$ 34
Billed (or accrued) to Interlink by Qualstar	-	44	-	54
Paid by Interlink to Qualstar	-	(45)	-	(87)
Billed (or accrued) to Qualstar by Interlink	385	-	475	-
Paid by Qualstar to Interlink	(447)	-	(511)	-
Balance at June 30,	$ 23	$ 7	$ 16	$ 1

BKF Capital Group, Inc.

BKF Capital Group, Inc. (OTCMKTS: BKFG) is a related party. Steven N. Bronson, our President and Chief Executive Officer and Director, is also the Chief Executive Officer and Chairman of the Board of BKF Capital. Ryan J. Hoffman, our Chief Financial Officer, is also the Chief Financial Officer of BKF Capital. BKF Capital, together with Mr. Bronson, has a controlling interest in Qualstar. We have consulting agreements with BKF Capital for certain of our respective employees and/or independent contractors that provide operational and general and administrative services to the other entity. We entered into a M&A advisory consulting services agreement with Bronson Financial LLC ("BF"), a wholly owned subsidiary of BKF Capital, in which BF provides M&A advisory consulting services to us. Qualstar and BKF Capital agree to reimburse, or be reimbursed by, one another for expenses paid by one company on behalf of the other. Transactions with BKF Capital are as follows:

	Three Months Ended June 30,			
	2022		2021	
	Due to BKF Capital	Due from BKF Capital	Due to BKF Capital	Due from BKF Capital
	(in thousands)			
Balance at April 1,	$ -	$ -	$ -	$ -
Billed (or accrued) to BKF Capital by Qualstar	-	30	-	-
Paid by BKF Capital to Qualstar	-	(30)	-	-
Billed (or accrued) to Qualstar by BKF Capital	1	-	3	-
Paid by Qualstar to BKF Capital	(1)	-	(3)	-
Balance at June 30,	$ -	$ -	$ -	$ -

	Six Months Ended June 30,			
	2022		2021	
	Due to BKF Capital	Due from BKF Capital	Due to BKF Capital	Due from BKF Capital
	(in thousands)			
Balance at January 1,	$ -	$ -	$ -	$ -
Billed (or accrued) to BKF Capital by Qualstar	-	60	-	-
Paid by BKF Capital to Qualstar	-	(60)	-	-
Billed (or accrued) to Qualstar by BKF Capital	1	-	3	-
Paid by Qualstar to BKF Capital	(1)	-	(3)	-
Balance at June 30,	$ -	$ -	$ -	$ -

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

Overview

Qualstar Corporation and its Subsidiaries ("Qualstar", the "Company", "we", "us" or "our") manufactures and markets data storage system products and compact, high efficiency power solutions. Our data storage systems are marketed under the Qualstar brand and 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 medical.

Qualstar Corporation was incorporated in California in 1984 and currently has three wholly owned subsidiaries. The N2Power, Inc. subsidiary (N2Power) operates the Company's power supplies business. The Q-Smart Data Limited (China) subsidiary pursues new data storage business opportunities in Asia. The Qualstar Limited (U.K.) subsidiary expands the Company's data storage business in Europe and Africa. The Company's former Qualstar Corporation Singapore Private Limited subsidiary previously gave the Company an engineering footprint in Singapore, and the Company's former Q-Smart Data Private Limited (Singapore) subsidiary previously pursued new business opportunities in Asia, both of which were dissolved in March 2022.

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

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

RESULTS OF OPERATIONS (Unaudited)

The following tables are presented in thousands, except for percentages. The percentages in this table are based on revenues.

	Three Months Ended June 30,				Six Months Ended June 30,			
	2022		2021		2022		2021	
	$	%	$	%	$	%	$	%
Data storage revenues	$ 1,209	64.9 %	$ 1,766	60.3 %	$ 2,788	65.2 %	$ 2,734	59.1 %
Power supplies revenues	654	35.1	1,163	39.7	1,485	34.8	1,892	40.9
Revenues	1,863	100.0	2,929	100.0	4,273	100.0	4,626	100.0
Cost of goods sold	1,382	74.2	1,847	63.1	3,069	71.8	3,098	67.0
Gross profit	481	25.8	1,082	36.9	1,204	28.2	1,528	33.0
Operating expenses:								
Engineering	118	6.3	87	3.0	168	3.9	261	5.6
Sales and marketing	336	18.0	359	12.3	659	15.4	764	16.5
General and administrative	348	18.7	74	2.5	660	15.4	362	7.8
Total operating expenses	802	43.0	520	17.8	1,487	34.8	1,387	30.0
Income (loss) from operations	(321)	(17.2)	562	19.2	(283)	(6.6)	141	3.0
Other income (expense), net	(68)	(3.7)	2	0.1	(67)	(1.6)	1	0.0
Income (loss) before taxes	(389)	(20.9)	564	19.3	(350)	(8.2)	142	3.1
Provision for income taxes	-	-	-	-	-	-	-	-
Net income (loss)	$ (389)	(20.9) %	$ 564	19.3 %	$ (350)	(8.2) %	$ 142	3.1 %

Revenues:

	Three months ended June 30,				Change	
	2022		2021			
	Amount	% of Revenues	Amount	% of Revenues	$	%
Data storage revenues	$ 1,209	64.9 %	$ 1,766	60.3 %	$ (557)	(31.5) %
Power supplies revenues	654	35.1	1,163	39.7	(509)	(43.8)
Revenues	$ 1,863	100.0 %	$ 2,929	100.0 %	$ (1,066)	(36.4) %

	Six months ended June 30,				Change	
	2022		2021			
	Amount	% of Revenues	Amount	% of Revenues	$	%
Data storage revenues	$ 2,788	65.2 %	$ 2,734	59.1 %	$ 54	2.0 %
Power supplies revenues	1,485	34.8	1,892	40.9	(407)	(21.5)
Revenues	$ 4,273	100.0 %	$ 4,626	100.0 %	$ (353)	(7.6) %

The decreases in revenues for the three and six months ended June 30, 2022 compared to the prior year periods are attributable to the segment-specific factors described below.

Segment Revenue

Data Storage – For the three months ended June 30, 2022 compared to the corresponding period in the prior year we experienced a 37% decrease in our data storage product revenues attributable to a decrease in shipments of our tape-based data storage products and solutions in the current quarter as compared to the same year-ago quarter, and a 7% decrease in our data storage service revenues as a result of a corresponding decrease in technical support services rendered during the quarter ended June 30, 2022 as compared to corresponding quarter in the prior year. For the six months ended June 30, 2022 compared to the corresponding period in the prior year we experienced a 5% increase in our data storage product revenues attributable to an increase in shipments in the current year-to-date period as compared to the prior year, and a 9% decrease in our data storage service revenues as a result of a corresponding decrease in technical support services rendered during the current year as compared to the prior year.

Power Supplies – The decreases in power supplies revenues in the three-month and six-month periods ended June 30, 2022 compared to the corresponding periods in the prior year were due to decreased shipments to our customers of our power supplies products and solutions in the current year, due in part to supply chain constraints and shortages of certain components.

Gross Profit:

	Three months ended June 30,					
	2022		2021		Change	
	Amount	% of Revenues	Amount	% of Revenues	$	%
Gross profit	$ 481	25.8 %	$ 1,082	36.9 %	$ (601)	(55.5) %

	Six months ended June 30,					
	2022		2021		Change	
	Amount	% of Revenues	Amount	% of Revenues	$	%
Gross profit	$ 1,204	28.2 %	$ 1,528	33.0 %	$ (324)	(21.2) %

The gross profit and gross margin percentage decreases for the three months ended June 30, 2022 compared to the corresponding period in the prior year are primarily due to decreases in revenue in both our data storage and power supplies segments, as well as unfavorable changes in customer and product mix. The gross profit and gross margin percentage decreases for the six months ended June 30, 2022 compared to the corresponding year-to-date period in the prior year are primarily due to the decrease in revenue in our power supplies segment, as well as unfavorable changes in customer and product mix.

Operating Expenses:

	Three months ended June 30,					
	2022		2021		Change	
	Amount	% of Revenues	Amount	% of Revenues	$	%
Engineering	$ 118	6.3 %	$ 87	3.0 %	$ 31	35.6 %
Sales and marketing	336	18.0	359	12.3	(23)	(6.4)
General and administrative	348	18.7	74	2.5	274	370.3
Total operating expenses	$ 802	43.0 %	$ 520	17.8 %	$ 282	54.2 %

	Six months ended June 30,					
	2022		2021		Change	
	Amount	% of Revenues	Amount	% of Revenues	$	%
Engineering	$ 168	3.9 %	$ 261	5.6 %	$ (93)	(35.6) %
Sales and marketing	659	15.4	764	16.5	(105)	(13.7)
General and administrative	660	15.4	362	7.8	298	82.3
Total operating expenses	$ 1,487	34.8 %	$ 1,387	30.0 %	$ 100	7.2 %

Engineering

Engineering expenses increased for the three months ended June 30, 2022 compared to the same period in the prior year primarily due to increased engineering and product-development activities and costs in the power supplies segment. Engineering expenses decreased for the six months ended June 30, 2022 compared to the same year-to-date period in the prior year primarily due to a decrease in the number of engineering employees in the data storage segment and lower engineering and product-development activities and costs in the power supplies segment.

Sales and Marketing

Sales and marketing expenses decreased for the three months and six months ended June 30, 2022 compared to the same periods in the prior year primarily due to a decrease in sales and marketing employees and consultants.

General and Administrative

General and administrative costs increased for the three months and six months ended June 30, 2022 compared to the same periods in the prior year primarily due to inclusion in the prior year of the $258 thousand gain/benefit recorded in connection with forgiveness of the PPP loan.

Liquidity and Capital Resources

As of June 30, 2022, cash, cash equivalents, and restricted cash decreased $1.123 million to $3.072 million from $4.195 million at December 31, 2021. Refer to the following discussions of sources and uses of cash during the period.

Operating Activities

Cash used in operating activities was $1.123 million for the six months ended June 30, 2022 compared to cash provided by operating activities of $739 thousand for the first half of the prior year. Cash used in operations for the six months ended June 30, 2022 was primarily the result of net loss of $350 thousand, non-cash expenses of $22 thousand, and cash used in changes in operating assets and liabilities and $795 thousand. Cash provided by operations for the six months ended June 30, 2021 was primarily the result of $142 thousand of net income, $831 thousand of cash provided by changes in operating assets and liabilities, and $24 thousand of non-cash expenses, offset by $258 thousand of non-cash PPP loan forgiveness gain.

Investing Activities

No cash was provided by or used in investing activities during the six months ended June 30, 2022. Cash used in investing activities was $38 thousand for the six months ended June 30, 2021, which was primarily comprised of purchases of warehouse equipment, furniture, fixtures, and computer equipment.

Financing Activities

No cash was provided by or used in financing activities during the six months ended June 30, 2022. Cash provided by financing activities was $263 thousand during the six months ended June 30, 2021, which consisted of proceeds from second draw PPP loans received during the second quarter of 2021.

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.