Qualstar Corporation and Subsidiaries

Quarterly Report for the Periods Ended
March 31, 2021 and 2020

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

QUALSTAR CORPORATION AND SUBSIDIARIES

TABLE OF CONTENTS

Item 1. Financial Statements

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

	March 31, 2021	December 31, 2020
Assets		
Current assets:		
Cash and cash equivalents	$ 4,601	$ 4,157
Restricted cash	100	100
Accounts receivable, net	701	1,379
Inventories	1,726	1,910
Prepaid expenses and other current assets	117	164
Total current assets	7,245	7,710
Property and equipment, net	95	103
Right-of-use assets	380	428
Deferred tax assets	30	30
Other assets	34	35
Total assets	$ 7,784	$ 8,306
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 595	$ 666
Accrued payroll and related liabilities	149	214
Deferred service revenue	631	600
Lease liabilities, current	111	254
PPP loan	258	258
Other accrued liabilities	224	183
Total current liabilities	1,968	2,175
Long-term liabilities:		
Lease liabilities, long term	293	198
Deferred service revenue, long-term	278	274
Other long-term liabilities	40	42
Total long-term liabilities	611	514
Total liabilities	2,579	2,689
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; shares issued and outstanding 1,953,359 at March 31, 2021, and 1,950,025 at December 31, 2020	18,990	18,980
Accumulated deficit	(13,785)	(13,363)
Total shareholders' equity	5,205	5,617
Total liabilities and shareholders' equity	$ 7,784	$ 8,306

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

	Three Months Ended March 31,	
	2021	**2020**
Net revenues	$ 1,697	$ 2,054
Cost of goods sold	1,251	1,384
Gross profit	446	670
Operating expenses:		
Engineering	174	71
Sales and marketing	405	342
General and administrative	288	421
Total operating expenses	867	834
(Loss) from operations	(421)	(164)
Other income (expense), net	(1)	8
(Loss) before income taxes	(422)	(156)
Provision for income taxes	-	-
Net (loss)	$ (422)	$ (156)
Earnings (loss) per share:		
Basic	$ (0.22)	$ (0.08)
Diluted	$ (0.22)	$ (0.08)
Weighted average common shares outstanding:		
Basic	1,952	1,925
Diluted	1,952	1,925

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

	Common Stock		Accumulated	
Three Months Ended March 31, 2021	**Shares**	**Amount**	**Deficit**	**Total**
Balances at December 31, 2020	1,950	$ 18,980	$ (13,363)	$ 5,617
Share-based compensation	3	10	-	10
Net (loss)	-	-	(422)	(422)
Balances at March 31, 2021	1,953	$ 18,990	$ (13,785)	$ 5,205

	Common Stock		Accumulated	
Three Months Ended March 31, 2020	**Shares**	**Amount**	**Deficit**	**Total**
Balances at December 31, 2019	1,925	$ 18,848	$ (12,105)	$ 6,743
Share-based compensation	-	-	-	-
Net (loss)	-	-	(156)	(156)
Balances at March 31, 2020	1,925	$ 18,848	$ (12,261)	$ 6,587

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

	Three Months Ended March 31, 2021	Three Months Ended March 31, 2020
Cash flows from operating activities:		
Net (loss)	$ (422)	$ (156)
Adjustments to reconcile net (loss) to net cash provided by operating activities:		
Depreciation and amortization	8	15
Share-based compensation	10	-
Amortization of right-of-use assets	48	75
Changes in operating assets and liabilities:		
Accounts receivable	678	1,316
Inventories	184	(334)
Prepaid expenses and other assets	46	24
Accounts payable	(71)	(340)
Accrued payroll and related liabilities	(65)	(20)
Deferred service revenue	35	(3)
Lease liabilities	(49)	(76)
Other liabilities	42	(63)
Net cash provided by operating activities	444	438
Cash flows from investing activities:		
Purchases of property and equipment	-	(24)
Net cash used in investing activities	-	(24)
Net cash provided by financing activities	-	-
Net increase in cash, cash equivalents, and restricted cash	444	414
Cash, cash equivalents, and restricted cash at beginning of period	4,257	3,963
Cash, cash equivalents, and restricted cash at end of period	$ 4,701	$ 4,377
Reconciliation of cash, cash equivalents and restricted cash, end of period:		
Cash and cash equivalents, end of period	$ 4,601	$ 4,277
Restricted cash, end of period	100	100
Cash, cash equivalents and restricted cash, end of period	$ 4,701	$ 4,377

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 now medical with our new product offerings.

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

We sell our products globally through authorized resellers, distributers, and directly to OEMs. 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. 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., Qualstar Corporation Singapore Private Limited, Qualstar Limited and Q-Smart Data Private Limited. All significant intercompany accounts and transactions have been eliminated in consolidation.

Estimates and Assumptions

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

COVID-19 Pandemic

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

we conduct business and our ability to maintain the level of business as planned for the coming months due to COVID-19.

Revenue Recognition

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

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

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 March 31, 2021 we had deferred service revenue of approximately $909,000. At December 31, 2020, we had deferred service revenue of approximately $892,000.

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 March 31, 2021 and December 31, 2020, $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
Leasehold improvements	3-5 years
Computer equipment	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, 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.

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, accounts payable, and PPP loan, 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 periods ended March 31, 2021 and 2020, 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 May 11, 2021, 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 (in thousands):

	March 31, 2021	December 31, 2020
Inventories	(In thousands)	
Raw materials	$ 278	$ 101
Finished goods	1,448	1,809
Net inventory balance	$ 1,726	$ 1,910

	March 31, 2021	December 31, 2020
Property and equipment, net	(In thousands)	
Machinery and equipment	$ 609	$ 609
Furniture and fixtures, and computer equipment	260	260
Leasehold improvements	78	78
	947	947
Less accumulated depreciation and amortization	(852)	(844)
Property and equipment, net	$ 95	$ 103

Depreciation and amortization expense for the three months ended March 31, 2021 and 2020 was $8,000 and $15,000, respectively.

Accrued payroll and related liabilities	March 31, 2021	December 31, 2020
	(In thousands)	
Accrued salaries, wages, and payroll taxes	$ 34	$ 99
Accrued vacation	115	115
Total accrued payroll and related liabilities	$ 149	$ 214

Other accrued liabilities	March 31, 2021	December 31, 2020
	(In thousands)	
Accrued warranty	$ 188	$ 144
Accrued outside commissions	36	31
Other accrued liabilities	-	8
Total other accrued liabilities	$ 224	$ 183

Note 3 – 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 March 31,	
	2021	2020
Net (loss)	$ (422)	$ (156)
Weighted average outstanding shares of common stock	1,952	1,925
Dilutive potential common shares from employee stock options	-	-
Common stock and common stock equivalents	1,952	1,925
Earnings (loss) per share:		
Basic earnings (loss) per share	$ (0.22)	$ (0.08)
Diluted earnings (loss) per share	$ (0.22)	$ (0.08)

For the three months ended March 31, 2021 and 2020, 140,633 and 178,000 outstanding stock options were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive.

Note 4 – Share-Based Compensation and Stock Incentive Plans

Share-Based Compensation

The Company did not incur expense for share-based compensation associated with outstanding share-based compensation awards for the three-month periods ended March 31, 2021 and 2020. No income tax benefit was recognized in the condensed consolidated statements of operations for share-based arrangements in any period presented. At March 31, 2021, the Company did not have any unrecognized compensation costs related to share-based compensation.

Stock Incentive Plans

The Company has two stock incentive plans as described below.

Qualstar adopted the 2008 Stock Incentive Plan (the "2008 Plan") under which incentive and nonqualified stock options and restricted stock could be granted for shares of common stock. The 2008 Plan has expired, and no additional options may be granted under that plan. However, as of March 31, 2021, 3,333 options that were previously granted under the 2008 Plan 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, of which 173,700 shares remain available for issuance as of March 31, 2021. 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, 2020	140,633	$ 7.18	6.47	$ -
Granted	-	-		
Exercised	-	-		
Forfeited, canceled or expired	(14,333)	8.07		
Outstanding at March 31, 2021	126,300	7.08	6.35	-
Exercisable at March 31, 2021	126,300	$ 7.08	6.35	$ -

Note 5 – Paycheck Protection Program Loan

In May 2020, the Company received a loan from Wells Fargo Bank, N.A. in the aggregate principal amount of $258,000 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. The loan is evidenced by a promissory note, dated May 4, 2020, issued by us to the lender, which matures on May 3, 2022, and bears interest at a rate of 1.00% per annum, payable monthly 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 the 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 have applied for forgiveness 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.

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.

Two customers accounted for 22% and 12% of the Company's net revenue for the three-month period ended March 31, 2021. One customer accounted for 12% of the Company's net revenue for the three-month period ended March 31, 2020.

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. Sales outside North America represented approximately 20.0% and 40.9% of net revenues for the three months ended March 31, 2021 and 2020, respectively.

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

	Three Months Ended March 31,			
	2021		2020	
North America	$ 1,357	80.0 %	$ 1,213	59.1 %
Europe	192	11.3	374	18.2
Asia Pacific	127	7.5	455	22.2
Other	21	1.2	12	0.6
	$ 1,697	100.0 %	$ 2,054	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. 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 entered into a lease for a facility in Camarillo, California beginning June 1, 2019. The facility is 9,910 square feet and is a 5-year and two-month lease, expiring July 31, 2024. The rent on this facility is $9,910 per month with a 3% step-up annually. Qualstar permits Interlink Electronics, Inc. ("Interlink") and BKF Capital Group, Inc. ("BKF Capital") 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 and BKF Capital are related parties.

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 $4,500 per month.

The Company previously leased a 15,160 square foot facility located in Simi Valley, California. The three-year lease began in December 2014 and was renewed for an additional three years through February 28, 2021. In May 2019, Qualstar entered into a sublease agreement with a subtenant, for this facility. The term of the sublease commenced in July 2019 and ended on February 28, 2021. Prior to entering the sublease, Qualstar subleased a portion of the facility space to Interlink and was reimbursed for the space and other related expenses on a monthly basis.

Qualstar also previously leased approximately 5,400 square feet of office space in Westlake Village, California, that expired January 31, 2020, and was not renewed. In March 2016, Qualstar entered into a sublease agreement with a subtenant for this facility. The term of the sublease expired at the same time as the term of the master lease.

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

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%, derived from borrowing rate quotes as obtained from the Company's business bank. 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 March 31, 2021, 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 March 31, 2021, the Company had current and long-term operating lease liabilities of $111,000 and $293,000, respectively, and right-of-use assets of $380,000.

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

	Minimum Lease Payment
2021 (remainder of year)	$ 94
2022	129
2023	133
2024	79
2025	-
Thereafter	-
Total undiscounted future non-cancelable minimum lease payments	435
Less: Imputed interest	(31)
Present value of lease liabilities	$ 404

During the three months ended March 31, 2021 and 2020, the Company incurred approximately $37 thousand and $25 thousand, respectively, of operating lease costs, which are included in operating expenses in our condensed consolidated statement 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 March 31, 2021.

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 Power Supplies and Data Storage. The two segments discussed in this analysis are presented in the way we internally manage and monitor performance for the three months ended March 31, 2021 and 2020. The types of products and services provided by each segment are summarized below:

Data 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.

Power Supplies — The Company designs and markets high-efficiency switching power supplies. We utilize contract manufacturers in Asia to produce our power supplies products. These power supplies are used to convert AC line

voltage to DC voltages, or DC voltages to other DC voltages for use in a wide variety of electronic equipment such as communications equipment, industrial machine tools, wireless systems, as well as medical and gaming devices. We sell our products globally through authorized resellers and directly to original equipment manufacturers.

Segment revenue, income before taxes and total assets were as follows:

	Three Months Ended March 31,	
	2021	2020
	(In thousands)	
Revenue		
Data Storage:		
Product	$ 680	$ 740
Service	288	559
Total Data Storage	968	1,299
Power Supplies	729	755
Revenue	$ 1,697	$ 2,054

	Three Months Ended March 31,	
	2021	2020
	(In thousands)	
Income (Loss) before Taxes		
Data Storage	$ (148)	$ 55
Power Supplies	(274)	(211)
Income (loss) before taxes	$ (422)	$ (156)

	March 31, 2021	December 31, 2020
	(In thousands)	
Total Assets		
Data Storage		
Cash and cash equivalents	$ 3,956	$ 3,901
Restricted cash	100	100
Accounts receivable, net	526	829
Inventories	1,224	1,191
Prepaid expenses and other current assets	97	136
Property and equipment, net	93	101
Right-of-use assets	380	428
Other assets	64	65
Total Data Storage assets	6,440	6,751
Power Supplies		
Cash and cash equivalents	645	256
Accounts receivable, net	175	550
Inventories	502	719
Prepaid expenses and other current assets	20	28
Property and equipment, net	2	2
Total Power Supplies assets	1,344	1,555
Total Assets	$ 7,784	$ 8,306

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 office 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. In addition, we have various 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 March 31,			
	2021		2020	
	Due to Interlink	Due from Interlink	Due to Interlink	Due from Interlink
	(in thousands)			
Balance at January 1,	$ 52	$ 34	$ 24	$ 12
Billed (or accrued) to Interlink by Qualstar	-	31	-	33
Paid by Interlink to Qualstar	-	(58)	-	(38)
Billed (or accrued) to Qualstar by Interlink	208	-	128	-
Paid by Qualstar to Interlink	(145)	-	(151)	-
Balance at March 31,	$ 115	$ 7	$ 1	$ 7

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 previously had a facilities agreement with BKF Capital to allow BKF Capital to use of a portion of our Camarillo, California office facility, for which we had agreed to split substantially all rent and facilities-related costs on an apportioned basis according to the approximate relative usage levels by each entity. This facilities agreement ceased in November 2020. Qualstar and BKF Capital also agree to reimburse, or be reimbursed by, one another for expenses paid by one company on behalf of the other. For the three months ended March 31, 2021 and 2020, BKF Capital paid us $0 and $1,000, respectively, for its use of our Camarillo office facility and other expense reimbursements.

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 now medical with our new product offerings.

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

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. N2Power utilizes contract manufacturers in Asia to produce our power solutions products.

RESULTS OF OPERATIONS - (Unaudited)

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

	Three Months Ended March 31,					
	2021			2020		
	$	%		$	%	
Data storage revenues	$ 968	57.0	%	$ 1,299	63.2	%
Power supplies revenues	729	43.0	%	755	36.8	%
Net revenues	1,697	100.0	%	2,054	100.0	%
Cost of goods sold	1,251	73.7	%	1,384	67.4	%
Gross profit	446	26.3	%	670	32.6	%
Operating expenses:						
Engineering	174	10.3	%	71	3.5	%
Sales and marketing	405	23.9	%	342	16.7	%
General and administrative	288	17.0	%	421	20.5	%
Total operating expenses	867	51.1	%	834	40.6	%
(Loss) from operations	(421)	(24.8)	%	(164)	(8.0)	%
Other income (expense), net	(1)	(0.1)	%	8	0.4	%
(Loss) before income taxes	(422)	(24.9)	%	(156)	(7.6)	%
Provision for income taxes	-	-	%	-	-	%
Net (loss)	$ (422)	(24.9)	%	$ (156)	(7.6)	%

Net Revenues:

	Three months ended March 31,								
	2021			2020			Change		
	Amount	% of net revenue		Amount	% of net revenue		$	%	
Data storage revenues	$ 968	57.0	%	$ 1,299	63.2	%	$ (331)	(25.5)	%
Power supplies revenues	729	43.0		755	36.8		(26)	(3.4)	
Net revenues	$ 1,697	100.0	%	$ 2,054	100.0	%	$ (357)	(17.4)	%

The decrease in net revenues for the three months ended March 31, 2021 compared to the prior year period is attributable to the segment-specific factors described below.

Segment Revenue

Data Storage – For the three months ended March 31, 2021 compared to the corresponding period in the prior year we experienced an approximately 8% decline in our data storage product revenues primarily attributable to the macro-economic effect of the COVID-19 pandemic on our customers. Data storage service revenues also decreased as a result of the termination of our partnership with Sony Imaging Products & Solutions Inc. for the development of an enterprise class optical disk archive library, and also as a result of a decline of approximately 11% in technical support revenues for the three months ended March 31, 2021 as compared to the prior year period.

Power Supplies – The decrease in power supplies revenues in the three months and year ended March 31, 2021 compared to the prior year period is primarily attributable to the continuing impact that the COVID-19 pandemic has had on many of our customers in the United States and abroad, for which demand for our power supplies has been negatively impacted.

Gross Profit:

	Three months ended March 31,					
	2021		2020		Change	
	Amount	% of net revenue	Amount	% of net revenue	$	%
Gross profit	$ 446	26.3 %	$ 670	32.6 %	$ (224)	(33.4) %

The gross profit decrease for the three months ended March 31, 2021 compared to the corresponding period in the prior year is primarily attributed to our reduced net revenues. The decrease in gross margin percentage for the three months ended March 31, 2021 compared to the prior year is attributed to the change in mix between data storage products and services and power supplies products.

Operating Expenses:

	Three months ended March 31,					
	2021		2020		Change	
	Amount	% of net revenue	Amount	% of net revenue	$	%
Engineering	$ 174	10.3 %	$ 71	3.5 %	$ 103	145.1 %
Sales and marketing	405	23.9	342	16.7	63	18.4
General and administrative	288	17.0	421	20.5	(133)	(31.6)
Total operating expenses	$ 867	51.1 %	$ 834	40.6 %	$ 33	4.0 %

Engineering
Engineering expenses increased for the three months ended March 31, 2021 compared to the same period in the prior year primarily due to an increase in the number of engineering employees in both the data storage segment and the power supplies segment in the current year compared to the prior year.

Sales and Marketing
Sales and marketing expenses increased during the three months ended March 31, 2021 compared to the prior year period primarily due to an increase in sales and marketing employees and consultants in the current year compared to the prior year.

General and Administrative
General and administrative costs decreased for the three months ended March 31, 2021 compared to the same period in the prior year primarily due to decreases in administrative, professional, and legal fees associated with having previously been a reporting company registered with the U.S. Securities and Exchange Commission.

Liquidity and Capital Resources
As of March 31, 2021, cash, cash equivalents, and restricted cash increased $444,000 to $4,701,000 from $4,257,000 at December 31, 2020.

Operating Activities
Cash provided by operating activities was $444 thousand for the three months ended March 31, 2021 compared to cash provided by operating activities of $438 thousand for the first quarter of the prior year. Cash provided by operations for the three months ended March 31, 2021 was primarily the result of $800 thousand of cash provided by changes in operating assets and liabilities and $66 thousand of non-cash expenses, offset by net loss of $422 thousand.
Cash provided by operations for the three months ended March 31, 2020 was primarily the result of $504 thousand of cash provided by changes in operating assets and liabilities and $90 thousand of non-cash expenses, offset by net loss of $156 thousand.

Investing Activities
Cash used in investing activities was $0 for the three months ended March 31, 2021 compared to $24 thousand for the first quarter of the prior year. Cash used in investing activities primarily consists of purchases of warehouse equipment, furniture, fixtures, and computer equipment.

Financing Activities
There was no cash provided by or used in financing activities during the three months ended March 31, 2021 or 2020.

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.