Qualstar Corporation and Subsidiaries

Quarterly Report for the Three Months Ended March 31, 2020 and 2019

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QUALSTAR CORPORATION
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2020
TABLE OF CONTENTS

ITEM 1. Financial Statements

QUALSTAR CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	March 31, 2020 (Unaudited)	December 31, 2019
Assets		
Current assets:		
Cash and cash equivalents	$ 4,277	$ 3,863
Restricted cash	100	100
Accounts receivables, net	1,050	2,366
Inventories, net	2,874	2,540
Prepaid expenses and other current assets	237	211
Total current assets	8,538	9,080
Non-current assets:		
Property and equipment, net	130	122
Right-of-use	601	676
Other assets	111	160
Total non-current assets	842	958
Total assets	$ 9,380	$ 10,038
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 689	$ 1,029
Accrued payroll and related liabilities	172	192
Deferred service revenue, short-term	700	702
Lease liabilities, short term	225	252
Other accrued liabilities	318	368
Total current liabilities	2,104	2,543
Long-term liabilities:		
Other long-term liabilities	39	52
Lease liabilities, long term	404	453
Deferred service revenue, long term	246	247
Total long-term liabilities	689	752
Total liabilities	2,793	3,295
Shareholders' equity:		
Preferred stock, no par value; 5,000,000 shares authorized; no shares issued	-	-
Common stock, no par value; 50,000,000 shares authorized, shares issued and outstanding 1,925,025 at March 31, 2020 and at December 31, 2019	18,848	18,848
Accumulated deficit	(12,261)	(12,105)
Total shareholders' equity	6,587	6,743
Total liabilities and shareholders' equity	$ 9,380	$ 10,038

See notes to condensed consolidated financial statements.

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

	Three Months Ended March 31,	
	2020	**2019**
Net revenues	$ 2,054	$ 2,856
Cost of goods sold	1,384	1,936
Gross profit	670	920
Operating expenses:		
Engineering	71	123
Sales and marketing	342	308
General and administrative	421	353
Total operating expenses	834	784
Income (loss) from operations	(164)	136
Other income	8	5
Income (loss) before income taxes	(156)	141
Provision for income taxes	-	-
Net Income (loss)	$ (156)	$ 141
Earnings (loss) per share:		
Basic	$ (0.08)	$ 0.07
Diluted	$ (0.08)	$ 0.07
Shares used in per share calculation:		
Basic	1,925	1,971
Diluted	1,925	1,971

See notes to condensed consolidated financial statements.

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

	Three Months Ended March 31, 2020				
	Common Stock		Accumulated Other Comprehensive Income	Accumulated	
	Shares	Amount	(Loss)	Deficit	Total
Balances at December 31, 2019	**1,925**	**$ 18,848**	**$ —**	**$ (12,105)**	**$ 6,743**
Stock repurchase	—	—	—	—	—
Net income (loss)	—	—	—	(156)	(156)
Balances at March 31, 2020	**1,925**	**$ 18,848**	**$ —**	**$ (12,261)**	**$ 6,587**

	Three Months Ended March 31, 2019				
	Common Stock		Accumulated Other Comprehensive Income	Accumulated	
	Shares	Amount	(Loss)	Deficit	Total
Balances at December 31, 2018	**2,030**	**$ 19,426**	**$ —**	**$ (12,098)**	**$ 7,328**
Stock repurchase	(59)	(329)	—	—	(329)
Net income	—	—	—	141	141
Balances at March 31, 2019	**1,971**	**$ 19,097**	**$ —**	**$ (11,957)**	**$ 7,140**

See notes to condensed consolidated financial statements.

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

	Three months Ended March 31, 2020	Three months Ended March 31, 2019
Cash flows from operating activities:		
Net income (loss)	$ (156)	$ 141
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15	13
Provision for inventory obsolescence	44	36
Amortization of right of use	75	33
Changes in operating assets and liabilities:		
Accounts receivable	1,316	64
Inventories	(378)	86
Prepaid expenses and other current assets	24	(21)
Accounts payable	(340)	(80)
Accrued payroll and related liabilities	(20)	(10)
Deferred service revenue	(3)	1
Lease liabilities	(76)	(36)
Other accrued liabilities	(63)	(14)
Total adjustments	594	72
Net cash provided by operating activities	438	213
Cash flows from investing activities:		
Purchases of equipment	(24)	-
Net cash used in investing activities	(24)	-
Cash flows from financing activities:		
Purchase of common stock	-	(329)
Net cash provided by (used in) financing activities	-	(329)
Net increase (decrease) in cash, restricted cash and cash equivalents	414	(116)
Cash, restricted cash and cash equivalents at beginning of period	3,963	4,881
Cash, restricted cash and cash equivalents at end of period	$ 4,377	$ 4,765
Supplemental cash flow disclosures:		
Income taxes paid	$ -	$ -

See notes to condensed consolidated financial statements.

Note 1 – Significant Accounting Policies

Basis of Presentation

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

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

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

Principles of Consolidation

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

Estimates and Assumptions

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

QUALSTAR CORPORATION AND SUBSIDIARIES

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, 2020 we had deferred service revenue of approximately $946,000. At December 31, 2019, we had deferred service revenue of approximately $949,000.

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. When legal costs that the entity expects to incur in defending itself in connection with a loss contingency accrual are expected to be material, the loss should factor in all costs and, if the legal costs are reasonably estimable, they should be accrued in accordance with ASC 450, regardless of whether a liability can be estimated for the contingency itself. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. Changes in these factors could materially impact our condensed consolidated financial statements. No loss contingency was reported as of March 31, 2020.

Fair Value of Financial Instruments

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

Accounting for Income Taxes

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

Leases

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

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

Operating Segments

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

Note 2 – Recent Accounting Pronouncements

Recent accounting guidance not yet adopted

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

Note 3 – Balance Sheet Details

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

Inventories, net

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

	March 31, 2020	December 31, 2019
	(unaudited)	
Raw materials	$ 165	$ 199
Finished goods	2,709	2,341
Net inventory balance	$ 2,874	$ 2,540

Property and equipment, net

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

	March 31, 2020	December 31, 2019
	(unaudited)	
Leasehold improvements	$ 79	$ 163
Furniture and fixtures	248	268
Machinery and equipment	621	609
	948	1,040
Less accumulated depreciation and amortization	(818)	(918)
Property and equipment, net	$ 130	$ 122

Depreciation and amortization expense for the three months ended March 31, 2020 and 2019 was $15,000 and $13,000 (unaudited), respectively.

Other Accrued Liabilities

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

	March 31, 2020	December 31, 2019
	(unaudited)	
Accrued warranty	$ 274	$ 290
Accrued outside commissions	39	55
Other accrued liabilities	5	23
Total other accrued liabilities	$ 318	$ 368

Note 4 - Contingencies

Accrued Warranty

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

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

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

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

	Three months Ended March 31, 2020	Year Ended December 31, 2019
	(unaudited)	
Beginning balance	$ 290	$ 365
Cost of warranty claims	(4)	(21)
Accruals for product warranties	(12)	(54)
Ending balance	$ 274	$ 290

Note 5 – Net Earnings Per Share

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

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

	Three Months Ended March 31, 2020	2019
	(unaudited)	(unaudited)
Net Income (loss) (a)	$ (156)	$ 141
Weighted average outstanding shares of common stock (b)	1,925	1,971
Dilutive potential common shares from employee stock options	-	-
Common stock and common stock equivalents (c)	1,925	1,971
Income (loss) per share:		
Basic net income (loss) per share (a)/(b)	$ (0.08)	$ 0.07
Diluted net income (loss) per share (a)/(c)	$ (0.08)	$ 0.07

For the three months ended March 31, 2020 and 2019, 155,633 and 178,000 outstanding stock options were excluded from the calculation of diluted net income per share as their inclusion would have been anti-dilutive.

Note 6 – Stockholders' Equity

On December 5, 2018, the board of directors approved a stock repurchase program (the "Stock Repurchase Program") to repurchase shares of the Company's common stock. The program permitted repurchases of up to a maximum aggregate purchase price of $2,400,000 and the number of shares of Common Stock repurchased shall not exceed 409,000. Under the Stock Repurchase Program, 58,734 shares were repurchased during the three months ended March 31, 2019 and a total of 148,093 shares were repurchased during the program. The program expired December 5, 2019.

Note 7 – Stock Incentive Plans and Share-Based Compensation

Share-Based Compensation

The Company did not incur an expense for share-based compensation associated with outstanding stock options for the three months ended March 31, 2020 and 2019. No income tax benefit was recognized in the condensed consolidated statements of operations for share-based arrangements in any period presented. At March 31, 2020, the Company did not have any unrecognized compensation costs related to share-based compensation.

Stock Option Plan

The Company has two share-based compensation plans as described below.

Qualstar adopted the 2008 Stock Incentive Plan (the "2008 Plan") under which incentive and nonqualified stock options and restricted stock could be granted for shares of common stock. The 2008 Plan has expired and no additional options may be granted under that plan. However, 3,333 options that were previously granted under the 2008 Plan will continue under their terms.

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

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

The following table summarizes stock option activity:

Options	Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2019	161,333	$ 7.17	7.74	—
Granted	—	—	—	—
Exercised	—	—	—	—
Forfeited, canceled or expired	(5,700)	7.17	—	—
Outstanding at March 31, 2020	155,333	7.17	7.24	—
Exercisable at March 31, 2020	155,333	$ 7.17	7.24	$ —

Note 8 – Income Taxes

We did not record a provision or benefit for income taxes for the three months ended March 31, 2020 and 2019, as the Company has net operating loss carryforwards available to offset taxable income. The Company released $30,000 valuation allowance against its net deferred tax assets based on the Company’s assessment regarding the realizable nature of these net deferred tax assets in future periods. The 2017 federal tax return was examined in 2019 and provided a no change notice by the Internal Revenue Service.

Note 9 – Significant Customers, Concentration of Credit Risk and Geographic Information

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

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

	Three Months Ended March 31,			
	2020		2018	
Revenue – geographic activity (in thousands):	(unaudited)		(unaudited)	
North America	$ 1,213	59.1 %	$ 1,919	67.2 %
Europe	374	18.2 %	580	20.3 %
Asia Pacific	455	22.2 %	334	11.7 %
Other	12	0.6 %	23	0.8 %
	$ 2,054	100.0 %	$ 2,856	100.0 %

One customer accounted for 11.5% of the Company’s net revenue for the three-month period ended March 31, 2020. At March 31, 2020, the same customer was 0.5% of the accounts receivable balance. The accounts receivable balances totaled 1.6% of net accounts receivable for the same customer as of December 31, 2019.

Two customers accounted for 12.7% and 10.1% of the Company’s net revenue for the three-month period ended March 31, 2019. At March 31, 2019, the same two customers were 19.0% of the accounts receivable balance.

Note 10 - Commitments

Lease Agreements

The Company entered into a lease in Camarillo, California for its corporate headquarters beginning June 1, 2019. The facility is 9,910 square feet and is a 5 year and two-month lease, expiring July 31, 2024. The rent on this facility is $9,910 per month with a 3% step-up annually. Qualstar subleases a portion of the warehouse space to Interlink Electronics, Inc. (“Interlink”) and BKF Capital Group, Inc. (“BKF”) and is reimbursed for the space and other related expenses on a monthly basis. As described in Note 12, Interlink and BKF are related parties.

Qualstar leases a 15,160 square foot facility located in Simi Valley, California. The three-year lease began December 15, 2014 and has been renewed for an additional three years, expiring February 28, 2021. Rent on this facility is $11,400 per month with a step-up of 3% annually. On May 22, 2019, Qualstar entered into a Standard Sublease Multi-Tenant (the “Sublease”), with Stillwater Agency, Inc., a California corporation (“Stillwater”), for the Simi Valley location, which previously served as Qualstar’s corporate headquarters location and principal executive office. The term of the Sublease commenced on July 15, 2019 and ends on February 28, 2021 (the “Term”). The base rent under the Sublease is approximately $12,886 per month. Stillwater is also responsible for approximately nine percent (9%) of certain operating expenses and taxes associated with the office building in which the leased premises are located. Prior to entering the Sublease, Qualstar subleased a portion of the warehouse space to Interlink and was reimbursed for the space and other related expenses on a monthly basis.

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

Effective April 1, 2016, the Company leased 1,359 square feet of office space for $2,500 per month in Singapore, which expired March 31, 2020. This lease was not renewed.

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

The rate implicit in each lease is not readily determinable, and we therefore use our incremental borrowing rate to determine the present value of the lease payments. The weighted average incremental borrowing rate used to determine the initial value of right of use (ROU) assets and lease liabilities during the three months ended March 31, 2020 was 4.33%, derived from borrowing rate quotes as obtained from the Company's business bank. We have certain contracts for real estate which may contain lease and non-lease components which we have elected to treat as a single lease component.

Right of use assets for operating leases are periodically reduced by impairment losses. We use the long-lived assets impairment guidance in ASC Subtopic 360-10, Property, Plant, and Equipment – Overall, to determine whether a ROU asset is impaired, and if so, the amount of the impairment loss to recognize. As of March 31, 2020, we have not recognized any impairment losses for our ROU assets.

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

At March 31, 2020, the Company had current and long-term operating lease liabilities of $225,000 and $404,000, respectively, and right of use assets of $601,000.

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

Years Ending March 31,	**Minimum Lease Payment**	**Sublease Revenue**	**Net Minimum Lease Payment**
Remainder of 2020	$ 194	$ (116)	$ 78
2021	148	(26)	122
2022	129		129
2023	133		133
2024	79		79
Total undiscounted future non-cancelable minimum lease payments	683	(142)	541
Less: Imputed interest	(54)		(54)
Present value of lease liabilities	$ 629	$ (142)	$ 487

Net rent expense for the three months ended March 31, 2020 and 2019 was $33,000 and $37,000, respectively.

Other information related to our operating leases is as follows:

		Three Months Ended March 31, 2020
Weighted average remaining lease term in years		1.31
Weighted average discount rate		4.33%
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	$	83
Operating cash flows from finance leases		-
Financing cash flows from finance leases		-

Note 11 – Segment Information

In its operation of the business, management reviews certain financial information, including segmented internal profit and loss statements prepared on a basis consistent with U.S. GAAP. Our two segments are Power Supplies and Data Storage. The two segments discussed in this analysis are presented in the way we internally manage and monitor performance for the three months ended March 31, 2020 and 2019. Our allocations of internal resources were made to the two business segments for the three months ended March 31, 2020 and 2019. The types of products and services provided by each segment are summarized below:

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

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

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

	Three Months Ended March 31,			
	2020		2019	
	(unaudited)		(unaudited)	
Revenue				
Power Supplies	$	755	$	1,370
Storage:				
Product		740		783

Service	559	703
Total storage	$ 1,299	$ 1,486
Revenue	$ 2,054	$ 2,856

	Three Months Ended March 31, 2020 (unaudited)	2019 (unaudited)
Income (loss) before Taxes		
Power Supplies	$ (211)	$ (10)
Storage	55	151
Income (loss) before taxes	$ (156)	$ 141

QUALSTAR CORPORATION AND SUBSIDIARIES

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

	March 31, 2020	December 31, 2019
Total Assets		
Power Supplies		
Cash and cash equivalents	$ 706	$ 527
Accounts receivable, net	435	840
Inventories, net	1,107	872
Property and equipment	4	11
Other assets	90	107
	2,342	2,357
Data Storage		
Cash and cash equivalents	3,571	3,336
Restricted cash	100	100
Accounts receivable, net	615	1,526
Inventories, net	1,767	1,668
Property and equipment	126	111
Right of use	601	676
Other assets	258	264

	7,038	7,681
Total Assets	$ 9,380	$ 10,038

Note 12 -Related Party Transactions

Steven N. Bronson is the Company's CEO and is also the President and CEO and a majority shareholder of Interlink Electronics, Inc. ("Interlink") and BKF Capital Group, Inc. ("BKF"). Interlink reimburses Qualstar for leased space at the Camarillo facility and, previously the Simi Valley facility and for other administrative expenses paid by or on behalf of the Company. The total amount charged to Interlink for the three months ended March 31, 2020 and 2019, was $28,000 and $6,000, respectively. Interlink owed Qualstar $2,000 and $5,000 at March 31, 2020 and December 31, 2019, respectively.

The Company reimburses Interlink for expenses paid on the Company's behalf. The Company has entered into various Consulting Agreements with Interlink. Pursuant to the Consulting Agreements, Interlink performs marketing and administrative services to the Company. Interlink receives approximately, $40,000 per month, plus expenses for these services. Also, Interlink occasionally pays travel and other expenses incurred by Qualstar employees. The Company reimbursed Interlink $127,000 and $57,000 for the three months ended March 31, 2020 and 2019, respectively. Qualstar owed Interlink $1,000 and $25,000, at March 31, 2020 and December 31, 2019, respectively.

The Company reimburses BKF for expenses paid on the Company's behalf. BKF occasionally pays consulting expenses incurred by Qualstar. BKF paid the Company $1,000 for the three months ended March 31, 2020 and no amount for the three months ended March 31, 2019. The Company no expenses were paid to BKF for the three months ended March 31, 2020 and $2,000 was reimbursed to BKF for the three months ended March 31, 2019. No amount was owed to BKF as of March 31, 2020 and 2019.

Note 13 – Subsequent Events

COVID - 19 Pandemic

The outbreak in December 2019 of the novel coronavirus (COVID-19) that began in China resulted in global quarantines, business closures, limitations on shipping and receiving product, restricted travel, cancellations of tradeshows and general economic disruptions. We cannot presently predict the scope and severity of the continued business shutdowns and disruptions of our suppliers, distributers, resellers and other third parties with whom we conduct business and our ability to maintain the level of business as planned.

NASDAQ Delisting

Effective April 30, 2020, Qualstar voluntarily delisted its common stock from The NASDAQ Stock Market and based on ownership of its shares by fewer than 300 holders of record, deregistered its common stock under the Securities Exchange Act of 1934 and will suspend its public reporting obligations. Qualstar will trade its common stock on the Pink tier of the OTC Markets Group.

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

RESULTS OF OPERATIONS - (Unaudited)

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

	Three Months Ended March 31,			
	2020		2019	
	$	%	$	%
Power supply revenues	$ 755	36.8 %	$ 1,370	48.0 %
Storage revenues	1,299	63.2 %	1,486	52.0 %
Net revenues	2,054	100.0 %	2,856	100.0 %
Cost of goods sold	1,384	67.4 %	1,936	67.8 %
Gross profit	670	32.6 %	920	32.2 %
Operating expenses:				
Engineering	71	3.5 %	123	4.3 %
Sales and marketing	342	16.6 %	308	10.8 %
General and administrative	421	20.5 %	353	12.4 %
Total operating expenses	834	40.6 %	784	27.5 %
Income (loss) from operations	(164)	(8.0) %	136	4.7 %
Other income	8	0.4 %	5	0.2 %
Net income (loss)	$ (156)	(7.6) %	$ 141	4.9 %

<u>Comparison of the Three Months Ended March 31, 2020 and 2019 (unaudited)</u>

Change in Net Revenues:

	Three months Ended March 31,				Change	
	2020		2019			
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Power supply revenues	$ 755	36.8 %	$ 1,370	48.0 %	$ (615)	(44.9) %
Storage revenues	1,299	63.2 %	1,486	52.0 %	(187)	(12.6) %
Net revenues	$ 2,054	100.0 %	$ 2,856	100.0 %	$ (802)	(28.1) %

The increase in net revenues for the three months ended March 31, 2020 compared to the prior year period is attributable to the segment-specific factors described below.

Segment Revenue

<u>Power Supplies</u> – The decrease in power supply sales in the three months ended March 31, 2020 compared to the prior year period is primarily attributable to the COVID-19 pandemic. Initially, the extended Chinese New Year halted production with our contract manufacturer in China. As China went back into production, many of our customers in the United States and abroad were shut down. The limited demand for our power supplies has continued with customers that manufacture critical products or are in geographic areas that are not on lock down.

<u>Storage</u> – For the three months ended March 31, 2020 compared to the prior year period we experienced a decline in our storage product sales primarily attributable to the COVID-19 pandemic as businesses globally were locked down. Service revenue also decreased as a result of the termination of our partnership with Sony Imaging Products & Solutions Inc. for the development of an enterprise class optical disk archive ("ODA") library, also with the decline in technical support revenue.

Gross Profit:

	Three months Ended March 31,		Change
	2020	2019	

	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Gross profit	$ 670	32.6 %	$ 920	32.2 %	$ (250)	(27.2) %

The gross profit decrease for the three months ended March 31, 2020 compared to the prior year period is primarily attributed to our power supply business. The reduced revenue did not contribute the same margins to apply to the fixed costs of the business as in the prior year.

Operating Expenses:

	Three months Ended March 31,				Change	
	2020		2019			
	Amount	% of net revenue	Amount	% of net revenue	Amount	%
Engineering	$ 71	3.5 %	$ 123	4.3 %	$ (52)	(42.3) %
Sales and marketing	$ 342	16.6 %	$ 308	10.8 %	$ 34	11.0 %
General and administrative	$ 421	20.5 %	$ 353	12.4 %	$ 68	19.3 %

Engineering

Engineering expenses decreased for the three months ended March 31, 2020 compared to the prior year, primarily due to the reduction in payroll and related expenses as there was an employee reduction.

Sales and Marketing

Sales and marketing expenses increased during the three months ended March 31, 2020 from the prior year period, primarily from an increase in marketing expenses offset by a reduction in commissions, tradeshows and promotional materials.

General and Administrative

General and administrative costs increased during the three months ended March 31, 2020 from the prior year period as a result of an increase in temporary labor costs, audit and legal fees and travel costs.

Other income

Other income increased as a result of interest earned during the three months ended March 31, 2020.

Provision for Income Taxes

We did not record a provision or benefit for income taxes for each of the three months ended March 31, 2020 and 2019, due to our net operating loss carryforwards (NOL's). There were no changes to the valuation allowance during the three months ended March 31, 2020 and 2019.

LIQUIDITY AND CAPITAL RESOURCES

As of March 31, 2020, cash, restricted cash and cash equivalents increased $414,000 to $4,377,000 from $3,963,000 at December 31, 2019.

Operating Activities

Our principal source of liquidity is cash generated from operations. Net cash provided by operating activities was $438,000 for the three months ended March 31, 2020 compared to the net cash provided by operating activities of $213,000 for the three months ended March 31, 2019.

The cash provided by operating activities for the three months ended March 31, 2020 of $438,000 consisted an increase of non-cash adjustments of $134,000 and an increase in the changes of operating assets and liabilities of $460,000 offset by the operating loss for the period of $156,000. The cash provided by the change in operating assets and liabilities was primarily due to the reduction of accounts receivable.

Investing Activities

Cash used for investing activities for the three months ended March 31, 2020 was $24,000 relating to the purchase of a new tradeshow booth and leasehold improvements on the Camarillo facility.

Financing Activities

There was no cash provided or used by financing activities for the three months ended March 31, 2020. Cash used by financing activities during the three months ended March 31, 2019 was $329,000 relating to the purchase of common stock under the Company's buy-back program.

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.