QUALSTAR CORP
Form 10-K
March 16, 2018

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark one)

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2017

OR

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

FOR THE TRANSITION PERIOD FROM __________ TO ____________

COMMISSION FILE NUMBER 001-35810

QUALSTAR CORPORATION

(Exact Name of registrant as specified in its charter)

CALIFORNIA	95-3927330
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
130 West Cochran Street, Unit C; Simi Valley, CA	93065
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (805) 583-7744

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:	Name of each exchange on which registered:
Common Stock	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company	Emerging growth company

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

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

As of June 30, 2017, the aggregate market value of the common equity held by non-affiliates of the registrant was approximately $7,415,671 based on the closing sales price as reported on the NASDAQ Stock Market. As of March 8, 2018 there were 2,045,519 shares of common stock without par value outstanding.

QUALSTAR CORPORATION

FORM 10-K

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2017

INDEX

1

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 ("Reform Act"). Forward-looking statements inherently are subject to risks and uncertainties, some of which we cannot predict or quantify. Therefore, our actual results may differ materially and adversely from the results projected in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in “ITEM 1A — Risk Factors,” and in “ITEM 7 — Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Words such as “believes,” “may,” “will,” “expects,” “intends,” “estimates,” “anticipates,” “plans,” “seeks,” or “continues,” variations of such words, and similar expressions are intended to identify such forward-looking statements. Forward-looking statements also include the assumptions underlying or relating to any such statements. Forward-looking statements contained within this document represent a good-faith assessment of Qualstar Corporation’s future performance for which management believes there is a reasonable basis. Qualstar Corporation disclaims any obligation to update the forward-looking statements contained herein, except as may be required by law.

PART I

ITEM 1. BUSINESS

INTRODUCTION

Qualstar Corporation and its Subsidiaries (“Qualstar”, the “Company”, “we”, “us” or “our”) is organized into two strategic business segments, power solutions and data storage systems. Qualstar is a leading provider of data storage systems marketed under the Qualstar brand and of high efficiency and high-density power solutions marketed under the N2Power brand. Qualstar Corporation was incorporated in California in 1984 and operates two wholly-owned subsidiaries. N2Power, Inc. was formed in 2017 to operate the Company’s power supply business and Qualstar Corporation Singapore Private Limited (“QC Singapore,”) was created in 2014 to give the Company an engineering footprint in Singapore and better service our contract manufacturers and our Asian distribution partners and customers. Qualstar’s N2Power branded power solutions products provide unique power solutions to original equipment manufacturers (“OEMs”) for a wide range of markets, including communications networking, industrial, gaming, test equipment, LED/lighting, medical as well as other market applications. Data storage system products include highly scalable automated magnetic tape-based storage solutions used to store, retrieve and manage electronic data primarily in the network computing environment and to provide solutions for organizations requiring backup, recovery and archival storage of critical electronic information.

Our storage products provide data protection and archive storage systems which are used to record, retrieve and manage electronic data, primarily in networked computing environments. Our storage products are compatible with a wide range of storage management software solutions such as those offered by QStar, Xendata, IBM, EMC, CommVault and Veritas. We offer products addressing the storage needs of the small and medium-size business market, as well as, to the enterprise market. In addition to storage products, we offer service and support programs for our customers.

Our N2Power products provide high-efficiency and high-density AC/DC and DC/DC power solutions for a variety of applications including gaming products and data center technologies such as switches, routers, data storage, servers and networking communications equipment. With a wide variety of feature-rich standard products and the ability to create custom and semi-custom products, we offer a comprehensive product line to OEMs that require high-value, high-efficiency power supplies to meet specific applications.

We design our products at our facilities in California and Singapore. We sell our products globally through authorized resellers and directly to OEMs. N2Power utilizes contract manufacturers in Asia to produce our power solutions products. Our storage products are manufactured by us at our factory in Simi Valley, California and by our OEM suppliers in other parts of the world.

DATA STORAGE INDUSTRY

Background

The data protection and archival storage markets are comprised of a few large suppliers and a number of medium and smaller companies that offer specialized products and capacity ranges. Solutions include both disk based and tape-based systems and related software.

The proliferation of digital data, e-commerce, big data, digital media streaming, and advanced software applications has created exponential growth in the production of digital information. As regulators and companies require the longer retention of and access to archived data, the market for products to store that data cost-effectively is needed. We believe this trend will drive continued demand for tape-based data storage products.

Strategy

Our primary objective in our storage business is to be a global leader in highly scalable, cost effective data protection and archival storage for the information technology markets. To achieve this objective, we plan to:

Continue to expand our sales channels and geographies. We have begun to accelerate the promotion of Qualstar storage solutions on a global basis and will continue to add resellers outside the US in addition to adding new US resellers.

Launch effective marketing campaigns which will increase market awareness of the Qualstar brand as well as reinforce tape's role within the storage arena. We plan on advertising in select industry vertical markets highlighting the storage solutions Qualstar provides for those sectors. We also plan on attending trade shows with our partners in order to leverage both their coverage of their markets and their branding in the marketplace.

Produce expandable storage solutions that deliver scalability within the data center and more effective capital spending for our customers. Expandability is a key requirement for many customers who are dealing with rapidly growing capacity needs on a regular basis. Expandability enables customers to easily and quickly add more storage while providing a cost-effective solution that can be readily budgeted during their planning cycles.

Expand our product line through private label offerings. We will continue to partner with other designers and manufacturers to offer private label products. In this way, we can provide customers with a broad product offering that expands beyond the product choices they have today.

Explore adjacent technologies to expand our functionality and footprint in the IT market. Historically we have been focused on products using magnetic tape as the media in our systems and on automating the loading, unloading and storage of the media. We will explore partnerships with software and disk manufacturers where reasonable to offer a complete data storage solution.

Expand our cost effective, service and support programs in international markets. We will investigate enhancing our service and support programs in international markets as we expand product sales in those regions.

Our Storage Solutions

Today's Linear Tape-Open ("LTO") based data storage solutions yield a compelling outcome for organizations struggling to cope with fast growing data, reliable data retention and budgetary pressure. Qualstar offers LTO based data storage devices for various vertically focused business units, including but not limited to, media and entertainment, oil and gas, high performance computing, education, telecom and life sciences.

We design, develop, manufacture and market storage products which deliver cost effective data protection and archival storage to small and medium sized businesses, and to more complex small and medium enterprise environments with stringent performance and data availability requirements. We provide a wide range of storage solutions that span data storage capacities.

Q Series **- Tape based data storage devices**

Qualstar offers a full range of entry level and mid-range data storage solutions for customers ranging from 10 Terabytes to 6.72 Petabytes. Our Q1 appliance offers an all-in-one solution for on-location data storage needs where as our Q24, Q48 and scalable Q80 tape libraries satisfy the required data storage capacities as well as data transfer rates of entry level and mid-range customers.

RLS Series **- Tape based data storage devices**

These are our “Simply Reliable” robust tape libraries that are designed and manufactured in the United States to satisfy the data storage needs of mid-range customers. With built-in library enabled encryption, individual robots in each cabinet and elevator mechanism to transfer cartridges from one cabinet to other, these tape libraries offer robust data protection at a low cost of ownership. Ranging from 50 to 474 slots, using LTO 8 tape technology these libraries offer between 600 Terabytes and 5.69 Petabytes of data storage capacity and up to a 23.8 Terabytes per hour data transfer rate.

XLS Series **- Enterprise Class Tape based storage devices**

XLS is Qualstar’s highly modular enterprise library system delivering intelligence, density, flexibility, scalability, and ease of use, coupled with our proven record of reliability and value. XLS features Compass Architecture™, an advanced robotics design that yields superior reliability and density. XLS can be expanded from 435 tapes in easy increments to over 11,700 tapes to offer more than 140 Petabytes of data storage capacity. Our unique LRM (Library Resource Module) and MEM (Media Expansion Module) combination allows maximum density of 1368 Terabytes per sq. foot.

POWER SUPPLY INDUSTRY

Background

The power supply industry is comprised of a few large suppliers and a vast number of smaller companies that focus on specialized products and markets. Currently, the power solutions markets for our N2Power brand products include the Servers, Storage and Network ("SSN"), Industrial and Transportation ("IND"), Network Power Systems ("NPS"), Medical, Gaming and LED/Lighting markets.

We believe the following key trends will continue to drive demand for our power solutions products:

Increasing amounts of power required by the communications infrastructure industry. The proliferation of data centers and their related infrastructures, the internet, wireless communications, broadband applications, server and storage farms and other new technologies have increased exponentially the amount of information transmitted. As a result, the push for higher bandwidth and more efficient and effective power solutions has been driving a faster replacement cycle for telecommunications equipment as well as strong infrastructure expansion.

Increasing demand for high conversion efficiencies, high power density and digital power management. Efforts in the EU, the United States and Asia to reduce energy consumption are increasing the demand for high conversion efficiencies and digital power control. In addition, groups such as the Climate Savers Computing Initiative, consisting of a consortium of companies including Google and Intel and other eco-conscious businesses and conservation organizations are promoting the development, deployment and adoption of smart technologies that can both improve the efficiency of a computer's power utilization and reduce the energy consumed when the computer is in an inactive state. Because a large portion of electrical energy waste occurs during the power conversion process, power companies have an opportunity to improve the conversion efficiency to reduce the operating costs for the end user. Our AC/DC power supplies provide conversion efficiency ratings up to 93%. Our digital power control technologies allow us to achieve high levels of power conversion efficiency and control that are not possible with analog designs. Higher conversion efficiencies help reduce overall power usage and therefore cut greenhouse gas emissions and total cost of infrastructure ownership.

Strategy

Our primary objective in our power supply business is to be a global leader in high-efficiency, high-density power solutions for the data center equipment, medical, gaming, test equipment, transportation, industrial and telecommunications network power markets. To achieve this objective, we plan to:

Continue to expand our sales channels and geographies. We promote the N2Power brand on a global basis and are targeting larger OEMs and distributers who have a presence in markets and geographies that we do not currently serve.

Continue to increase volume with our current OEM customers. Our OEM customers are constantly changing their products and introducing new products. We are striving to become the supplier of choice within our OEM customer base to leverage our existing relationships and drive volume growth within the same sales channel.

Continue to expand our footprint in the current markets we serve. We are currently supporting the data center equipment, medical, gaming, test equipment, transportation, industrial and telecommunications systems markets. We have secured several sizable OEM customers and are aiming to add new OEM customers in these markets.

Expand our product line while continuing to drive for higher power levels and greater conversion efficiencies in a smaller footprint. Minimizing space requirements within our customers' products is critical, and as a result there is a continuing need for smaller packaging while delivering additional power. Our product roadmap addresses these needs and our objective is to lead the industry with the greatest efficiency in the smallest footprint with the highest power available. In this way, we can deliver advantages to our OEM customers as they leverage our technology in their product designs.

Expand our product line through private label offerings. We have identified a need for utilizing other manufacturers' core products to complement our own, where we lack products in specific markets or power levels. To achieve this, we will utilize our relationships with other power solutions manufacturers.

Organize our technology resources for fast time to market on derivative products. Our customers continually request derivative configurations to our existing products. In order to serve this market effectively, we are organizing our engineering resources for fast turnaround on these designs to shorten our OEM customers' design cycle, leading to faster time to market.

Our Power Solution Products

We design, develop, manufacture and market our power solution products, whose purpose is to convert, regulate, purify, manage or distribute electrical power for electronic equipment. Our products are used in a variety of products and generally convert AC current from the grid to DC current, or modify the voltage being delivered (DC to DC). We typically target markets where high efficiency and power density are important to our customers.

We sell standard, modified-standard and custom designed products. Standard products are sold unmodified to our customers. Modified-standard products are based on lightly modified versions of standard products. Custom products are designed specifically to the customer's specification and are not generally sold to other customers. Custom products may require non-recurring engineering and tooling costs to bring the product to production. We are also an Optimized Product Design Manufacturer (OPDM). With our core competencies in both power and mechanical design, we offer complete custom power assemblies and eliminate the need for our customers to purchase additional components to integrate our power supplies into their products.

N2Power continues to introduce new products, such as:

The newly designed XL270 has a footprint of only 4" x 2" one of the most compact 270-Watt supplies on the market. This model offers outputs of 12, 24, 30, 48 and 56 Volts along with a 5Watt/5Volt standby output and a 6 Watt/12 Volt auxiliary output, with current sharing capabilities.

The new XLM240 is a multi-purpose product that is certified for use in both IT and medical equipment. It offers 240 Watts of output cooled by a 10 cu. ft. minute fan, or 160 Watts with unobstructed convection cooling. The product is ultra-compact and is offered with 12, 15, 24 and 48-volt outputs.

New models have been added to the XLM product line. The XLM500 is certified for use in both IT and medical equipment. This unit has a footprint of 5" x 3" delivering up to 500 Watts. The model is offered in 12, 15, 24, and 48 Volt outputs and can be in an open-frame or U-frame.

CUSTOMERS

Our solution-focused product offerings are designed specifically for OEMs, information technology departments, and lower and middle market companies. We sell our storage products through our worldwide authorized distributor and reseller network. Power supplies are sold through distributors and direct through independent outside sales representatives. All of our products and services are designed and manufactured to address our customers' stringent requirements and reliability standards. The following provides additional detail on our channels:

Storage Reseller channel. Our reseller channel includes systems integrators, value added resellers ("VARs") and value-added distributors ("VADs"). Our resellers frequently package our products as part of a comprehensive data processing system or with other storage devices to deliver a complete storage subsystem. Our resellers frequently recommend our products as replacement solutions when backup and archive systems are upgraded or bundle our products with storage management software specific to the end user's system. We support the reseller channel through our dedicated field sales representatives and technical support technicians.

Storage OEM channel. OEM customers incorporate our storage products with their application software and other components to deliver a focused solution. Our products may or may not carry our label.

N2Power OEM channel. We have supply agreements with our major power supply customers who incorporate our products into their server, gaming, network and industrial product offerings.

We divide our worldwide sales into three geographical regions:

Americas, consisting of Mexico, United States, Canada and South America;

EMEA, consisting of Europe, the Middle East and Africa; and

APAC, consisting of Asia Pacific countries.

7

We support our customers in the Americas primarily through a network of trained distribution partners and representatives located throughout the Americas. We support our EMEA, APAC and other foreign customers through our distributors and resellers located throughout the regions.

Sales to customers outside the United States represent a significant portion of our sales. International sales are subject to various risks and uncertainties. See "Risk Factors" in Part I, Item 1A of this report. The following table sets forth foreign revenue by geographic area ($ in thousands):

	Twelve Months Ended December 31,	
	2017	**2016**
Foreign revenue:		
EMEA	$1,910	$1,955
APAC	1,878	2,293
Other foreign revenue	224	92
	$4,012	$4,340
Foreign revenue as a percentage of total net revenue	37.7 %	46.1 %

We provide a full range of marketing materials for branded products, including product specifications, sales literature and application notes. We also offer lead generation opportunities to key channel partners. Our sales management and engineering personnel provide support to the channel partners and visit potential customer sites to demonstrate the technical advantages of our products. We maintain press relations in the United States, and we participate in trade shows worldwide.

CUSTOMER SERVICE AND SUPPORT

Customer service and support are key elements of our company strategy and critical components of our commitment to making enterprise-class support and services available to companies of all sizes. Our technical support staff is trained to assist our customers with deployment and compatibility for any combination of hardware platforms, operating systems and backup, data protection and storage management software. Our application engineers assist with complex customer issues. We maintain global toll-free service and support phone lines and we also provide self-service and support through our website and email.

Standard warranties include:

- Three-year standard limited warranty on our RLS and XLS tape library products;
- Two-year standard limited warranty on our “Q-Series” products;
- Optional 24x7 or next business day onsite service on our products in many countries throughout the world; and
- Three-year return to factory warranty on our N2Power products.

ENGINEERING

In the year ended December 31, 2017, our power supply team introduced the XL270 and XL500, which are key additions to our product portfolio. These new products provide a broader N2Power selection to OEM engineers to utilize in their designs. We continue to perform engineering work to improve our current products and create new products.

Our engineering efforts have expanded to encompass both the USA and Singapore. We have also formed strategic partnerships for supplementary engineering resources with third party companies in Europe and Asia to capture additional state-of-the-art technology driven power designs. Growing our engineering both internally and externally will allow us to increase our product breadth by releasing more standard and modified standard power solution products in the future.

We incurred engineering costs of $0.5 million and $1.0 million for the twelve months ended December 31, 2017 and 2016, representing 5.0%, and 10.5% of net revenues, respectively.

MANUFACTURING AND SUPPLIERS

We perform product assembly, integration and testing for our storage products at our factory in Simi Valley, California. Our private label storage products are manufactured in various geographical locations by a select group of suppliers. Our N2Power branded products are manufactured in China at specifically qualified contract manufacturers. We purchase tape drives, chassis, printed circuit boards, integrated circuits, and all other major components from outside suppliers. We carefully select suppliers based on their ability to provide quality parts and components which meet technical specifications and volume requirements. We actively monitor these suppliers but we are subject to substantial risks associated with the performance of our suppliers. For certain components, we qualify a single source, which magnifies the risk of shortages and decreases our ability to negotiate with that supplier. See "If our suppliers fail to meet our component and manufacturing needs, it would delay our production and our product shipments to customers and negatively affect our operations" under the heading "Risk Factors" in Part I, Section 1A of this report.

COMPETITION

The worldwide storage market is highly competitive. Competitors vary in size from small start-ups to large multi-national corporations which may have substantially greater financial, engineering and marketing resources than us. In the tape automation market, we believe our primary competitors are International Business Machines Corporation ("IBM"), Oracle/StorageTek, Dell Inc., Hewlett Packard, Sphere 3D (formally Overland Storage), Spectra Logic and Quantum Corporation. Key competitive factors include product features, reliability, durability, scalability and price. Barriers to entry in tape automation are relatively high as this is an established industry that is capital intensive.

Our primary power supply competitors are Artesyn, TDK Lambda, XP Power and Bel Power. Key competitive factors in these markets include price, performance, functionality, availability, interoperability, connectivity, time to market, enhancements and total value of ownership. Barriers to entry for power supply products are high as the industry is capital intensive.

The markets for all of our products are characterized by significant price competition and we anticipate that our products will continue to face substantial pricing pressure.

INTELLECTUAL PROPERTY

We rely on copyright protection of our firmware, as well as patent protection for some of our designs and products. We also rely on a combination of trademark, trade secret and other intellectual property laws to protect our proprietary rights. Despite our efforts to protect our proprietary rights, competition in our businesses is significant. We believe that, because of the rapid pace of technological change in the tape storage and power supply industries, patent, copyright, trademark and trade secret protection are less significant than factors such as market responsiveness, knowledge, ability and the experience of our personnel as well as timely new product introductions.

We enter into Employee Proprietary Information and Inventions Agreements with all employees and consultants to protect our technology and designs. However, we do not believe that such protection can preclude competitors from developing substantially equivalent products.

EMPLOYEES

As of December 31, 2017, we had 20 employees worldwide, 17 full-time and 3 part-time. We also employ a small number of consultants and temporary employees as needed. We are not a party to any collective bargaining agreement or other similar agreement. We believe that we have a good relationship with our employees.

AVAILABILITY OF SEC FILINGS

We are subject to the informational requirements of the Securities Exchange Act of 1934. Therefore, we file periodic reports, proxy statements and other information with the SEC. Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the SEC at 100 F Street N.E., Washington, D.C. 20549 or by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site (http://www.sec.gov) that contains reports, proxy and information statements and other information regarding issuers that file electronically. Our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge on our website as soon as reasonably practicable after we electronically file them with, or furnish them to, the SEC. Our website addresses are www.qualstar.com and www.n2power.com. Information contained on our web site is not part of this report on Form 10-K or our other filings with the SEC.

ITEM 1A. RISK FACTORS

Our future results of operations are subject to risks and uncertainties over which we have limited control, and which could cause our actual results to differ materially from our expectations. We are subject to all of the business risks facing manufacturing companies, including business cycles and trends in the general economy, financial market conditions, unpredicted cost variances in raw materials and purchased components, demand variations and volatility, potential loss of key personnel, supply chain disruptions, government legislation and regulation, and natural causes. The following list of risk factors is not all-inclusive. Other factors and unanticipated events could adversely affect our financial position or results of operations. We believe that the most significant potential risk factors that could adversely impact us are the following:

We have had a history of operating losses and we may not sustain profitability.

The Company achieved profitability in the year ended December 31, 2017. Prior to this year, the Company had a history of operating losses since fiscal year ended June 30, 2004. There is no assurance that management can sustain profitability.

We face intense industry competition, price erosion and product obsolescence, which, in turn, could reduce our operating results.

We operate in an industry that is generally characterized by intense competition and rapid technological change. We believe that the principal bases of competition in our markets are breadth of product line, quality of products, stability, reliability and reputation of the provider, along with cost. Quantity discounts, price erosion, and rapid product obsolescence due to technological improvements are therefore common in our industry as competitors strive to retain or expand market share. Product obsolescence can lead to increases in unsellable inventory that may need to be written off and therefore could reduce our operating results. Similarly, price erosion can reduce our operating results by decreasing our revenues and our gross margins.

Our long-term operating results depend substantially upon our ability to continually develop, introduce, and market new and innovative products, to modify existing products, to respond to technological change, and to customize certain products to meet customer requirements. There are numerous risks inherent in this process, including the risks that we will be unable to anticipate the direction of technological change or that we will be unable to develop and market new products and applications in a timely fashion to satisfy customer demands, which could result in a decrease in our net sales and a loss of market share to our competitors. Historically, we have had write-offs of excess and obsolete inventory which negatively impacted our results of operations. In the future, excess or obsolete inventory may need to be written off, and this in turn could reduce our operating results.

Changes in demand or downturns in the markets we serve could affect our business and operating results.

The industries into which we market and sell our products are cyclical and may experience downturns. These industries also experience volatility, and future volatility as well as downturns, or any failure of these industries to recover from downturns, could materially harm our business and operating results. Likewise, if we have difficulty managing growth in our businesses, it could materially and adversely affect us. In addition, our business and financial position may be adversely affected by current and future economic conditions that cause a decline in business and consumer spending in the markets served by our or our customers' products.

Our operating results may be impaired if demand for either technology declines or fails to develop as we expect.

We will continue to be subject to the risk of a decrease in revenues if demand for our products declines or if rising prices make it more difficult to sell them. If products incorporating other technologies gain comparable or superior market acceptance and competitive price advantage, our business, financial condition and operating results could be adversely and materially affected unless we successfully develop and market products incorporating the new technology.

Our principal competitors devote greater financial resources to developing, marketing and selling their products. Consequently, we may be unable to maintain or increase our market share.

We face significant competition in developing and selling our products. Rapid and ongoing changes in technology and product standards could quickly render our products less competitive, or even obsolete. We have significantly fewer financial, technical, manufacturing, marketing and other resources than many of our competitors and these limited resources may impair the operating results of our business in many ways. For example, in the past our competitors have offered wider ranges of products, expanded the geographic scope of their markets, acquired other companies, and developed or acquired proprietary technologies that operate in conjunction with their products.

In the future, our competitors may leverage their greater resources to:

develop, manufacture and market products that are less expensive or technologically superior to ours;

reach a wider array of potential customers through a broader range of marketing and distribution channels;

respond more quickly to new or changing technologies, customer requirements and standards; or

reduce prices in order to preserve or gain market share.

We believe competitive pressures are likely to continue. We cannot guarantee that our resources will be sufficient to address this competition or that we will manage costs and adopt strategies capable of effectively utilizing our resources. If we are unable to respond to competitive pressures successfully, our prices and profit margins may fall and our market share may decrease.

We rely on indirect sales channels to market and sell our branded storage products and both direct and indirect sales channels to market and sell our branded power solutions products. A loss of or deterioration in our relationship with one or more of our resellers or distributors, or our inability to establish new indirect sales channels to drive growth of our products could negatively affect our operating results.

We sell the majority of our branded storage products to value-added resellers, who in turn sell our products to end users. In some cases, resellers integrate our tape libraries with products of other manufacturers and sell the combined products to their own customers. We sell our branded power solution products both direct to OEM customers (or their contract manufacturers) and to our distribution channel who in turn sell our products to OEM customers. The success of these sales channels is hard to predict, particularly over time, and we have no purchase commitments or long-term orders from them that assure us of any baseline sales through these channels. Several of our resellers and distributors carry competing product lines that they may promote over our products, which may negatively impact our sales. A reseller or distributor might not continue to purchase our products or market them effectively, and each reseller or distributor determines the type and amount of our products that it will purchase from us and the pricing of the products that it sells to their customers. Establishing new indirect sales channels globally is an important part of our strategy to drive growth of our revenue.

Our operating results could be adversely affected by any number of factors including:

- A change in competitive strategy that adversely affects a reseller's or distributor's willingness or ability to distribute our products;
- Reaching fewer customers or losing sales due to ineffective efforts of resellers and distributors;
- Reduced margins and increased costs associated with channel sales;
- An inability to gain traction in developing new indirect sales channels for our branded products;
- Any financial difficulties of our resellers, authorized distributors or direct OEM customers that result in their inability to pay amounts owed to us;
- Changes in requirements or programs that allow our products to be sold by third parties to government customers; or
- Changes in product requirements or certification programs that limit our ability for our products to be sold in our established current markets.

We do not have any exclusive agreements with our VARs or distributors who purchase our products on an individual purchase order basis. If we lose important VARs or distributors, or if they reduce their focus on our products or if we are unable to obtain additional VARs, our business could be negatively affected.

If our suppliers fail to meet our component and manufacturing needs, it could delay our production and our product shipments to customers and negatively affect our operations.

Our products comprise many components and subassemblies produced by outside suppliers. We depend greatly on these suppliers for items that are essential to the manufacture of our products, including tape drives, printed circuit boards and integrated circuits. For certain items, we qualify only a single source, which magnifies the risk of shortages and decreases our ability to negotiate with that supplier on the basis of price. From time to time, we have been unable to obtain sufficient components that we have needed due to shortages or quality issues from some of our suppliers. If our suppliers fail to meet our manufacturing needs, it would delay our production and our product shipments to customers and negatively affect our operations.

We also rely on software vendors to develop and support software needed for operation of our automated tape library products and their integration into the user's computing environment. Accordingly, the continued development and future growth of the market for our tape library products will depend partly upon the ability of these vendors to meet the overall data storage and management needs of tape library purchasers and our ability to maintain relationships with these firms.

The primary suppliers of our N2Power power supplies are located in China. If a manufacturer should be unable to deliver products to us on a timely basis or at all, our power supply business could be adversely affected. Though we have had many years of favorable experience with these suppliers, there can be no assurance that circumstances might not change and compel one or more of these suppliers to curtail or terminate deliveries to us. Moreover, the use of contract manufacturers to provide our power supplies typically requires that we place production orders several months in advance of our expected need for the products. This in turn leads to risks that we may lack sufficient inventory to sell to our customers where our expectations were conservative, or that we may order excess product inventory where our expectations were optimistic. We have in the past, experienced shortages of some parts needed to manufacture our power supplies.

If we fail to develop and introduce new products on a timely and cost-effective basis, or if our products do not contain the features required by the marketplace, we may eventually lose market share and sales to competitors.

The market for our products is characterized by changing technology and evolving industry standards. Our future results will depend on our ability to anticipate changes in technology, to develop new and enhanced products on a timely and cost-effective basis, and to introduce, manufacture and achieve market acceptance of these new and enhanced products. With respect to our tape library products in particular, the introduction of new storage technologies or the adoption of an industry standard different from our current product standards could render our existing products obsolete.

Development schedules for high technology products are inherently subject to uncertainty and there can be no assurance that we will be able to meet our product development schedules or that our development costs will be within budgeted amounts. If the products or product enhancements developed are not deliverable due to technical problems, quality issues or component shortages, or if such products or product enhancements are not accepted by the marketplace or are unreliable, then our business, financial condition and results of operations may be adversely affected.

If we fail to protect our intellectual property or if others use our proprietary technology without authorization, our competitive position may suffer.

We rely on copyright protection of our software, firmware and electronic circuits, as well as patent protection for some of our products and product features. We also rely on a combination of trademark, trade secret, and other intellectual property laws and various contract rights to protect our proprietary rights. Despite our efforts to protect our proprietary rights, however, unauthorized parties may attempt to copy or otherwise obtain or use our products or technology. As a consequence, these rights may not preclude competitors from developing products that are substantially equivalent or superior to our products. In addition, many aspects of our products are not subject to intellectual property protection and therefore can be reproduced by others.

Undetected manufacturing flaws could increase our costs, reduce our revenues and divert resources from our core business needs.

Despite our efforts to revise and update our manufacturing and test processes to address engineering and component changes, we may not be able to control and eliminate manufacturing flaws adequately. These flaws may include undetected software or hardware defects associated with a newly introduced product, a new version of an existing product, or a product that has been integrated into a system or apparatus with the products of other vendors. If we fail to adequately monitor, develop and implement appropriate test and manufacturing processes we could experience a rate of product failure that results in substantial shipment delays, warranty costs or damage to our reputation. Product flaws may also consume our limited engineering resources and interrupt our development efforts. Significant product failures would increase our costs and result in the loss of future sales and be harmful to our business.

Much of our business is subject to risks associated with operations in foreign countries.

We generate a significant percentage of our revenue internationally, and we believe that international sales will continue to represent a substantial portion of our revenues. In addition, our manufacturing of power supply products is performed by contract manufacturers in Asia. We face risks that the countries in which we conduct business, or in which we have customers, suppliers, or contract manufacturers could:

Experience financial, economic or political instability;

Adopt laws that make the enforcement of our contractual or other legal rights and remedies difficult or uncertain;

Provide inadequate intellectual property protection for our technology;

Impose restrictions on the export or import of technology that would affect our ability to obtain supplies from, or sell products into, such countries;

Impose tariffs, quotas, taxes, other market barriers; or

Impose other laws, regulations or policies adversely affecting trade, investment or taxes, including those relating to the repatriation of funds and to withholding taxes.

Other risks and costs associated with international operations include:

- Currency exchange risk, to the extent that exchange rate fluctuations could make our products unaffordable to foreign purchasers or more expensive compared to those of foreign manufacturers;
- Compliance with laws and regulations in various regions in which we operate;
- Greater difficulty and longer delays in collecting accounts receivable from international customers; or
- Increased risk of shipping disruptions particularly in foreign countries experiencing political instability.

Change of board and senior management, and retention of key personnel.

Turnover in key management positions could temporarily harm our financial performance and results of operations. Loss of certain members of our senior management may disrupt operations and relations with key customers and distributors and our operating results could be adversely affected. Our capacity to develop and implement new technologies depends on our ability to employ personnel with highly technical skills. If we cannot attract and retain key technical personnel, our technical expertise may suffer, and our operating results could be adversely affected. In addition, it could be difficult, time consuming and expensive to replace any key management member or other critical personnel and no guarantee exists that we will be able to recruit suitable replacements or assimilate new key management personnel into our organization to achieve our operating objectives.

Intellectual property infringement claims brought against us could result in a substantial liability and significant costs, and as a result, our business, financial condition and operating results may be materially and adversely affected.

From time to time, we may become subject to claims or inquiries regarding an alleged unauthorized use by us of another party’s intellectual property. While we currently believe the amount of ultimate liability, if any, with respect to any such actions will not materially affect our financial position, results of operations or liquidity, the ultimate outcome of any license discussion or litigation is uncertain. Adverse resolution of any infringement claim could subject us to substantial liabilities and require us to refrain from manufacturing and selling certain products. In addition, the costs incurred in intellectual property litigation can be substantial, regardless of the outcome. As a result, our business, financial condition and operating results could be materially and adversely affected.

Our revenues and operating results may fluctuate unexpectedly from quarter to quarter, which may in turn affect our stock price.

Our quarterly revenues and operating results have fluctuated in the past, and are likely to vary in the future due to the various factors discussed above and others, including:

General economic conditions affecting spending and the rates of growth or decline in the markets we serve;

Variations in product order backlogs, and reductions in the size, delays in the timing, or cancellation of significant customer orders;

The timing of introductions and marketplace acceptance of new or enhanced products by us or our competitors;

Expansions or reductions in our relationships with distributors, VARs or OEM customers;

Unprofitable investments in engineering activities, or sales evaluation, testing, and acceptance processes;

Unforeseen warranty costs that exceed established reserves;

Timing and levels of our operating expenses; or

Emerging new technologies that change the nature of or need for our products.

We believe that period-to-period comparisons of our operating results may not necessarily be reliable indicators of our future performance. It is likely that in some future period our operating results will not meet your expectations or those of public market analysts. Any unanticipated change in revenues or operating results is likely to cause our stock price to fluctuate since such changes reflect new information available to investors and analysts. New information may cause investors and analysts to revalue our stock and this, in the aggregate, may cause fluctuations in our stock price.

Trading in our stock has historically been limited and our stock price has been volatile, which may affect your ability to sell your shares.

The average trading volume in our stock has been historically low, with little or no trading at all on some days. This, as well as the factors listed below, has caused the price of our stock to be volatile. Consequently, it may be difficult to sell your shares of our stock at the price you paid for them or at a price equal to that quoted on the NASDAQ Stock Market. Factors that may cause our stock price to fluctuate in the future include:

Quarterly variations in operating results, especially if they differ from our previously announced forecasts or forecasts made by analysts;

Announcements by us of anticipated future revenues or operating results, or by others concerning us, our competitors, our customers, or our industry;

The introduction of new technology or products by us or our competitors;

Comments about us and the data storage or power supply markets made by industry analysts or on Internet comment sites; or

Changes in earnings estimates by analysts or changes in accounting policies; in product pricing policies by us or our competitors; or in general economic conditions.

In addition, stock markets have experienced extreme price and volume volatility recently. This volatility has had a substantial effect on the market prices of securities of many smaller public companies for reasons frequently unrelated or disproportionate to the operating performance of the specific companies. These market fluctuations may adversely affect the market price of our common stock.

Certain provisions in our charter documents and California law may hinder or prevent a change in control of our company.

Certain provisions of our charter documents could make it difficult for a third party to obtain control of the Company. For example, our articles of incorporation and bylaws require that stockholders must timely inform our corporate secretary before a stockholders' meeting if they wish to nominate directors or submit proposals for shareholder approval and contain provisions that eliminate cumulative voting in the election of directors. In addition, subject to the rules of the NASDAQ Stock Market, our board of directors has the authority, without any action by the shareholders, to issue up to 5,000,000 shares of preferred stock and to fix the rights and preferences of such shares. These provisions may have the effect of delaying, deferring or preventing a change in control, may discourage bids for our common stock at a premium over its market price and may adversely affect the market price, and the voting and other rights of the holders of our common stock.

Our success depends in part on our CEO, who simultaneously leads other public corporations.

Steven N. Bronson, our Chief Executive Officer and President, simultaneously serves as the President and Chief Executive Officer of Interlink Electronics, Inc. (NASDAQ: LINK) and Chief Executive Officer and Chairman of BKF Capital Group, Inc. (OTCMKTS: BKFG). As a result, he divides his time among these companies and does not devote his full business time and attention to Qualstar’s business. Mr. Bronson currently works on average approximately 20 to 30 hours per week for Qualstar. There can be no assurance, however, that the amount of time Mr. Bronson devotes to our Company will not diminish from time to time for limited or extended periods as his other business obligations require a greater portion of his attention. Mr. Bronson is not required to spend a minimum amount of time on Qualstar business. Our continued success depends in part upon the availability and performance of Mr. Bronson, who possesses unique and extensive industry knowledge and experience as well as a deep understanding of our business and strategy. A reduction in Mr. Bronson’s services to Qualstar from their current levels due to his obligations to Interlink Electronics, BKF Capital or other organizations with which he is affiliated could have a disruptive effect, adversely impacting our ability to manage our business effectively and execute our business strategy.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Qualstar headquarters is located in Simi Valley, California. We occupy a building with 15,160 rentable square feet of space. Our three-year lease on this facility began December 15, 2014 and was renewed for an additional three years, expiring February 28, 2021. Rent for this facility is $11,000 per month. Prior to May 1, 2016, our headquarters were located in Westlake Village, California.

We lease a facility in Singapore with 1,359 square feet for our power supply engineering staff. The two-year lease was effective April 1, 2016 and renewed for one year, expiring March 31, 2019. Rent for this facility is $2,500 per month.

Qualstar entered into a lease for 5,400 square feet of rentable space at the Westlake Village, California facility, effective May 1, 2016 for our sales, finance and administration staff. Rent for this facility is approximately, $11,000 per month. On March 21, 2016, in order to reduce operating expenses, Qualstar subleased its Westlake Village facility for approximately $12,000 per month. The term of the sublease will expire on January 31, 2020, the same date the term of the master lease expires.

On July 1, 2015, Qualstar Corporation entered into a one-year sublease agreement with Interlink Electronics, Inc. The sublease agreement is for 1,000 square feet of space in the Qualstar building located in Simi Valley, California. Qualstar receives rent each month, equal to the base rent per square foot in the master lease, plus additional rent for common area services, utilities and other shared expenses. The space is used by Interlink Electronics for engineering and light manufacturing.

ITEM 3. LEGAL PROCEEDINGS

Qualstar is subject to a variety of claims and legal proceedings that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in the aggregate, will not have a materially adverse impact on our financial statements, these matters are subject to inherent uncertainties and management's view of these matters may change in the future. We accrue loss contingencies in connection with our commitments and contingencies, including litigation, when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. As of December 31, 2017, no accrual was necessary for fees and costs related to loss contingency matters.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Qualstar's common stock is traded on The NASDAQ Capital Market or NASDAQ (Symbol — QBAK). The following table sets forth the high and low closing sale prices of our common stock as reported by NASDAQ, during the periods indicated:

Period Ending	Date Range	High	Low
December 31, 2017:			
First Quarter	January 1 – March 31, 2017	$10.00	$2.70
Second Quarter	April 1 – June 30, 2017	$9.47	$3.89
Third Quarter	July 1 – September 30, 2017	$13.20	$5.16
Fourth Quarter	October 1 – December 31, 2017	$10.36	$6.23
December 31, 2016:			
First Quarter	January 1 – March 31, 2016	$4.92	$2.28
Second Quarter	April 1 – June 30, 2016	$4.44	$2.16
Third Quarter	July 1 – September 30, 2016	$5.90	$2.65
Fourth Quarter	October 1 – December 31, 2016	$4.14	$2.62

Holders

There were approximately 21 owners of record of Qualstar's common stock as of March 8, 2018, not including beneficial owners who own their stock in street name through Cede & Co. and others.

Dividend Policy

No dividends were declared in the twelve months ended December 31, 2017 or 2016. Any future determination to pay dividends will be at the discretion of the Company's Board of Directors and will depend upon, among many other factors, the Company's results of operations, financial condition, capital requirements and any contractual restrictions.

Recent Sales of Unregistered Securities

None

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

The following table provides additional information regarding Qualstar's equity compensation plans as of December 31, 2017:

Plan category	**(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights (1)**	**(b) Weighted-average exercise price of outstanding options, warrants and rights (1)**	**(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a) (2))**
Equity compensation plans approved by security holders	188,033	$ 7.38	34,700
Equity compensation plans not approved by security holders	—	—	—
Totals	188,033	$ 7.38	34,700

(1) Includes shares subject to stock options granted under the 2017 Stock Incentive Plan, the 2008 Stock Incentive Plan and the 1998 Stock Incentive Plan as of December 31, 2017. The 1998 Stock Incentive Plan and the 2008 Stock Incentive Plan have expired and no further options may be granted under those plans.

(2) Includes shares under the 2017 Stock Incentive Plan.

ITEM 6. SELECTED FINANCIAL DATA

Not required for smaller reporting companies.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis of our financial condition and results of operations in conjunction with the consolidated financial statements and the related notes to the consolidated financial statements included later in this Annual Report on Form 10-K. In addition to historical financial information, the following discussion contains forward-looking statements that reflect our plans, estimates, beliefs and expectations that involve risks and uncertainties. Our actual results and the timing of events could differ materially from those discussed in these forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Annual Report on Form 10-K, particularly in "Risk Factors" and "Forward-Looking Statements."

OVERVIEW

Qualstar Corporation was incorporated in California in 1984. Qualstar manufactures and sells automated tape libraries used to store, retrieve and manage electronic data under its Qualstar brand. Tape libraries consist of cartridge tape drives, tape cartridges and robotics to move the tape cartridges from their storage locations to the tape drives under software control. Qualstar's tape libraries provide storage solutions for organizations requiring backup, recovery and archival storage of critical electronic information. Qualstar's subsidiary, N2Power, Inc., designs, develops, manufactures and sells high efficiency AC-DC and DC-DC power supplies under the N2Power brand name.

Qualstar has developed a business plan to establish worldwide partnerships with other power supply and data storage related companies that will increase our engineering capabilities to develop new products and enable us to 'private label' and sell already established strategic products that fit within our portfolio of products.

Qualstar established a Singapore subsidiary in 2014, Qualstar Corporation Singapore Private Limited ("QC Singapore"), in furtherance of its plan to establish an engineering footprint in Asia. QC Singapore has allowed us to hire strategic engineering personnel to assist in sustaining our current products and for new product development. QC Singapore has helped us in servicing our Asian customers and allows us to enter into relationships with various Singapore technical schools that have a strong history of working with local businesses in development of new breakthrough technologies.

Beginning in the fiscal year ended June 30, 2015, the Company took substantial action to reduce overhead spending and to focus on achieving profitability. The Company reduced headcount, significantly downsized its facilities and reduced telecommunication costs.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our consolidated financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to loss contingencies, product life cycles and inventory obsolescence, bad debts, sales returns, warranty costs, share-based compensation forfeiture rates, and the potential outcome of future tax consequences. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

We recognize revenue in accordance with Accounting Standards Codification ("ASC") 605, "Revenue Recognition," when there is persuasive evidence that an arrangement exists, title and risk of loss have passed, delivery has occurred or the services have been rendered, the sales price is fixed or determinable and collection of the related receivable is reasonably assured. Title and risk of loss generally pass to our customers upon shipment. In limited circumstances where either title or risk of loss pass upon destination or acceptance or when collection is not reasonably assured, we defer revenue recognition until such events occur.

In general, customers are allowed to return the product, free of penalty, within thirty days of shipment, if the product does not conform to its specifications. We record an allowance for estimated sales returns based on past experience and current knowledge of our customer base. Our experience has been such that only a very small percentage of products are returned. Should our experience change, however, we may require additional allowances for sales returns.

Revenue for established products that have previously satisfied a customer's acceptance requirements and provide for full payment tied to shipment is generally recognized upon shipment and passage of title. In limited cases where a prior history of customer acceptance cannot be demonstrated or sales where customer payment dates are not determinable or when collection is not reasonably assured, revenue is deferred until customer acceptance occurs or payment has been received. On the limited shipments where sales are not recognized, gross profit is generally recorded as deferred profit in our balance sheet representing the difference between the receivable recorded and the inventory shipped.

Service contracts are sold by Qualstar to customers for a period of time to provide product support after the warranty expires. 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 providers.

Deferred revenue, which relates primarily to our service contracts, was approximately $927,000 and we had no deferred profit at December 31, 2017. Deferred revenue was approximately $892,000 and we had no deferred profit, at December 31, 2016.

Fair Value of Financial Instruments

We measure fair value on all financial assets and liabilities and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis (at least quarterly). See “Note 1 – Accounting Policies” in the accompanying notes to the consolidated financial statements.

Allowance for Doubtful Accounts

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

Inventory Valuation

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

Warranty Obligations

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

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. When legal costs that the entity expects to incur in defending itself in connection with a loss contingency accrual are expected to be material, the loss should factor in all costs and, if the legal costs are reasonably estimable, they should be accrued 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 financial statements.

Share-Based Compensation

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

Accounting for Income Taxes

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

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

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

The Company has net operating loss carry-forwards for federal income tax purposes of approximately $32.0 million and net operating loss carry-forwards for state income tax purposes of approximately $21.0 million. The Company has engineering and other credits for tax purposes of $2.1 million. If not utilized, the federal net operating loss will start to expire beginning in 2026 and other tax credit carry-forwards will start to expire beginning in 2025. If not utilized, the state net operating loss carry-forward as of December 31, 2017 will expire beginning in 2018. The state engineering credit has no limit on the carry-forward period.

Recent Accounting Pronouncements

See Recent Accounting Guidance in “Note 1 Summary of Significant Accounting Policies" in the accompanying notes to the consolidated financial statements for a full description of recent accounting pronouncements including the respective expected dates of adoption and effects on our results of operations and financial condition.

21

RESULTS OF OPERATIONS

The following table reflects, as a percentage of net revenues, consolidated statements of operations data for the periods indicated. The table summarizes the revenue for the Company's two business segments, data storage and power supplies, as discussed in Note 11 of our consolidated financial statements, in thousands.

	Twelve Months Ended December 31, 2017		2016	
Power supply revenues	$6,297	59.2 %	$5,601	59.5 %
Storage revenues:				
Product	2,427	22.8 %	1,949	20.7 %
Service	1,917	18.0 %	1,867	19.8 %
Total storage revenues	4,344	40.8 %	3,816	40.5 %
Net revenues	10,641	100.0%	9,417	100.0%
Cost of goods sold	6,392	60.1 %	6,824	72.5 %
Gross profit	4,249	39.9 %	2,593	27.5 %
Operating expenses:				
Engineering	535	5.0 %	990	10.5 %
Sales and marketing	1,239	11.6 %	1,229	13.1 %
General and administrative	1,818	17.1 %	1,587	16.9 %
Total operating expenses	3,592	33.8 %	3,806	40.5 %
Income (loss) from operations	657	6.2 %	(1,213)	(12.9)%
Other income	-	0.0 %	3	0.0 %
Income (loss) before income taxes	657	6.2 %	(1,210)	(12.9)%
Provision for income taxes	17	0.2 %	-	0.0 %
Net income (loss)	$640	6.0 %	$(1,210)	(12.9)%

Comparison of the Twelve Months Ended December 31, 2017 and 2016

Change in Net Revenues:

Twelve Months Ended December 31, 2017		2016		Change	
Amount	**% of net revenue**	**Amount**	**% of net revenue**	**Amount**	**%**

Power supply revenues	$6,297	59.2 %	$5,601	59.5 %	$696	12.4%
Storage revenues	4,344	40.8 %	3,816	40.5 %	528	13.8%
Net revenues	$10,641	100.0 %	$9,417	100.0 %	$1,224	13.0%

The increase in net revenues is attributed to the segment-specific factors as set forth below.

Segment Revenue

Power Supplies – The increase in sales is attributed to increased demand from our existing gaming customers. Key customers that incorporate our power supplies have variable life cycles and production demands. As some projects are accelerating and others approach end of life, the timing of new production creates a fluctuation in sales.

Storage – For the fiscal year ending December 31, 2017 compared to the prior year period, we experienced revenue growth from the sale of both products and services in our data storage segment. The increase in product revenues is attributed to new reseller relationships focused on media and entertainment, which resellers have a high demand for tape technology. With the release of LTO8 (Linear Tape-Open) tape technology and the capacity of tape libraries increasing by approximately 50%, the Company has seen a shift in sales to entry level and mid-size libraries. Our product portfolio is targeted to this market. Our service revenue increased slightly compared to the previous year, primarily due to the product development service revenue received from our recent partnership with Sony Imaging Products & Solutions Inc. for the development of an enterprise class optical disk archive ("ODA") library, offset by a slight reduction in our technical support revenue. Our technical support service revenue fluctuates with historical sales cycles and we have experienced a slight reduction in service contracts as our industry competes with cloud-based services.

Gross Profit:

	Twelve Months Ended December 31,					
	2017		**2016**		**Change**	
	Amount	**% of net revenue**	**Amount**	**% of net revenue**	**Amount**	**%**
Gross profit	$4,249	39.9 %	$2,593	27.5 %	$1,656	63.9%

The gross profit increase is primarily attributed to the increase in sales, decrease in write-offs for obsolete inventory and reserves for slow moving items and improved profit margins on service contracts.

Operating Expenses:

	Twelve Months Ended December 31,					
	2017		**2016**		**Change**	
	Amount	**% of net**	**Amount**	**% of net**	**Amount**	**%**

		revenue		revenue		
Engineering	$535	5.0 %	$990	10.5 %	$(455)	(46.0)%
Sales and marketing	$1,239	11.6 %	$1,229	13.1 %	$10	0.8 %
General and administrative	$1,818	17.1 %	$1,587	16.9 %	$231	14.6 %

Engineering

Engineering expenses decreased in the twelve months ended December 31, 2017 compared to 2016, as a result of the reduction in payroll and related expenses, consulting fees, compliance costs and facilities costs.

Sales and Marketing

Sales and marketing expenses for the twelve months ended December 31, 2017 compared to 2016 remained flat. In 2017, we incurred increased commissions related to our increase in sales which additional expenses were offset by a reduction in consulting fees, facilities costs and a decrease in marketing expenses.

General and Administrative

General and administrative costs increased for the twelve months ended December 31, 2017 compared to 2016, primarily due to the increase in share-based compensation expense for stock options awarded to employees and board members, bonuses, accounting fees and reserve for bad debts which expenses were offset by a reduction in legal fees and facilities costs.

Other Income:

For the twelve months ended December 31, 2017 compared to 2016, the Company had a decrease in investment income of $3,000, as the cash held in the investment account was moved to a non-interest-bearing account.

Provision for Income Taxes: For the twelve months ended December 31, 2017, the Company recorded a $17,000 tax provision. The provision was related to state franchise and income tax due to the income allocation. The Company has federal net losses and does not require a provision for federal taxes for the twelve months ended December 31, 2017. No provision for income taxes was required for the twelve months ended December 31, 2016 for federal or state purposes.

LIQUIDITY AND CAPITAL RESOURCES

Cash provided from operating activities was $1.0 million in the twelve months ended December 31, 2017 compared to $127,000 cash used in the twelve months ended December 31, 2016.

Cash used in investing activities was $40,000 in the twelve months ended December 31, 2017 compared to $45,000 in the twelve months ended December 31, 2016. Our investing activities primarily include tooling for new products, software upgrades, office furniture and fixtures and warehouse equipment for the leased facilities.

Cash was not used or acquired in financing activities in the twelve months ended December 31, 2017 and 2016.

The Company continues to focus on controlling operating expenses, maintaining profitability and improving cash flow. By introducing private label products, we have been able to get similar or greater margins without developing new products ourselves, allowing for less headcount and product risk. Since 2013, the Company has been adjusting headcount, facilities costs and other operating expenses to attain profitability. All of these efforts and our increase in revenue have contributed to our positive cash flow.

As of December 31, 2017, we had $4.7 million in cash and cash equivalents, and $100,000 in restricted cash, used as collateral for our corporate credit cards. We believe that our existing cash and cash equivalents 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 businesses, products or technologies that we believe are strategic. We periodically evaluate other companies and technologies for possible investment. In addition, we have made and may in the future make investments in companies with whom we have identified potential synergies.

SUMMARY OF CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The following is a summary of our future payments due, offset by sublease income, under contractual obligations as of December 31, 2017 (in thousands):

Contractual Obligations:	**Total**	**Less than 1 Year**	**1 to 3 Years**
Operating Leases	$ 428	$ 143	$ 285

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not required for smaller reporting companies.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Qualstar Corporation & Subsidiaries

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of Qualstar Corporation & Subsidiaries (the Company) as of December 31, 2017, and the related consolidated statements of comprehensive income, stockholders' equity, and cash flows for the year ended December 31, 2017, and the related notes (collectively referred to as the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017, and the consolidated results of its operations and its cash flows for the year ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audit, we are required to obtain an understanding of internal control over financial reporting, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

/s/RBSM LLP

We have served as the Company’s auditor since 2017.

Larkspur, CA

March 16, 2018

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Qualstar Corporation and Subsidiary

We have audited the accompanying consolidated balance sheet of Qualstar Corporation and Subsidiary (collectively, the "Company") as of December 31, 2016, and the related consolidated statements of comprehensive loss, shareholders' equity, and cash flows for the year ended December 31, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Qualstar Corporation and Subsidiary as of December 31, 2016, and the consolidated results of their operations and their cash flows for the year ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/Marcum LLP

Marcum, LLP

Los Angeles, CA

March 16, 2017

27

QUALSTAR CORPORATION

CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	December 31,	
	2017	**2016**
ASSETS		
Current assets:		
Cash and cash equivalents	$4,698	$3,691
Restricted cash	100	100
Accounts receivable, net	1,802	1,583
Inventories, net	1,564	1,360
Prepaid expenses and other current assets	163	166
Total current assets	8,327	6,900
Property and equipment, net	172	286
Other assets	68	77
Total assets	$8,567	$7,263
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,065	$888
Accrued payroll and related liabilities	173	222
Deferred service revenue	834	787
Other accrued liabilities	454	359
Total current liabilities	2,526	2,256
Other long-term liabilities	52	63
Deferred service revenue, long term	93	105
Total long-term liabilities	145	168
Total liabilities	2,671	2,424
Commitments and contingencies (Note 10)		
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; 2,042,019 shares issued and outstanding as of December 31, 2017 and 2016, respectively	19,480	19,063
Accumulated deficit	(13,584)	(14,224)
Total shareholders' equity	5,896	4,839
Total liabilities and shareholders' equity	$8,567	$7,263

The accompanying notes are integral to the consolidated financial statements.

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share amounts)

	Twelve Months Ended December 31,	
	2017	**2016**
Net revenues	$*10,641*	$*9,417*
Cost of goods sold	*6,392*	*6,824*
Gross profit	*4,249*	*2,593*
Operating expenses:		
Engineering	*535*	*990*
Sales and marketing	*1,239*	*1,229*
General and administrative	*1,818*	*1,587*
Total operating expenses	*3,592*	*3,806*
Income (loss) from operations	*657*	*(1,213*)
Other income	-	*3*
Income (loss) before income taxes	*657*	*(1,210*)
Provision for income taxes	*17*	-
Net income (loss)	$*640*	$*(1,210*)
Change in unrealized losses on investments	-	-
Comprehensive income (loss)	$*640*	$*(1,210*)
Net income (loss) per share:		
Basic and Diluted	$*0.31*	$*(0.59*)
Shares used to compute net income (loss) per share:		
Basic and Diluted	*2,042*	*2,042*

The accompanying notes are integral to the consolidated financial statements.

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands)

	Common Stock		Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	**Amount**			
Balances at December 31, 2015	***2,042***	***19,061***	**—**	***(13,014)***	***6,047***
Share-based compensation	—	*2*	—	—	*2*
Net loss	—	—	—	*(1,210)*	*(1,210)*
Balances at December 31, 2016	***2,042***	**$*19,063***	**$ —**	**$ *(14,224)***	**$*4,839***
Exercise of stock options	*1*	*4*	—	—	*4*
Share-based compensation	—	*413*	—	—	*413*
Net income	—	—	—	*640*	*640*
Balances at December 31, 2017	***2,043***	**$*19,480***	**$ —**	**$ *(13,584)***	**$*5,896***

The accompanying notes are integral to the consolidated financial statements.

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Twelve Months Ended December 31, 2017	**2016**
CASH FLOW FROM OPERATING ACTIVITIES:		
Net income (loss)	$640	$(1,210)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	154	182
Loss on disposal of assets	5	23
(Recovery) of doubtful accounts, net	(7)	(38)
Provision for inventory reserve	364	972
Share-based compensation	413	2
Changes in operating assets and liabilities:		
Accounts receivable	(212)	85
Inventories	(568)	112
Prepaid expenses and other assets	11	1
Accounts payable	177	132
Accrued payroll and related liabilities	(49)	(110)
Deferred service revenue	35	(206)
Other accrued liabilities	84	(72)
Net cash provided by (used in) operating activities	1,047	(127)
CASH FLOW FROM INVESTING ACTIVITIES:		
Purchases of equipment	(44)	(45)
Proceeds from the exercise of stock options	4	-
Net cash (used in) investing activities	(40)	(45)
NET INCREASE (DECREASE) IN CASH, RESTRICTED CASH AND CASH EQUIVALENTS	1,007	(172)
CASH, RESTRICTED CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,791	3,963
CASH, RESTRICTED CASH AND CASH EQUIVALENTS, END OF PERIOD	$4,798	$3,791
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Income taxes paid	$3	$9

The accompanying notes are integral to the consolidated financial statements.

QUALSTAR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note *1* – Significant Accounting Policies

Business

Qualstar Corporation and its Subsidiaries ("Qualstar", the "Company", "we", "us" or "our") is organized into *two* strategic business segments, power solutions and data storage systems. Qualstar is a leading provider of data storage systems marketed under the Qualstar brand and of high efficiency and high-density power solutions marketed under the *N2Power* brand. Qualstar Corporation was incorporated in California in *1984* and operates *two* subsidiaries. *N2Power,* Inc. was formed in *2017* to operate the Company's power supply business and Qualstar Corporation Singapore Private Limited ("QC Singapore") was created in *2014* to give the Company an engineering footprint in Singapore and better service our contract manufacturers and our Asian distribution partners and customers. Qualstar's *N2Power* branded power solutions products provide unique power solutions to original equipment manufacturers ("OEMs") for a wide range of markets, including communications networking, industrial, gaming, test equipment, LED/lighting, medical as well as other market applications. Data storage system products include highly scalable automated magnetic tape-based storage solutions used to store, retrieve and manage electronic data primarily in the network computing environment and to provide solutions for organizations requiring backup, recovery and archival storage of critical electronic information.

We design our products at our facilities in California and Singapore. We sell our products globally through authorized resellers and directly to OEMs. *N2Power* utilizes contract manufacturers in Asia to produce our power solutions products. Our storage products are manufactured by us at our factory in Simi Valley, California and by our OEM suppliers in other parts of the world.

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

Accounting Principles

The consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP").

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.

Revenue Recognition

We recognize revenue when there is persuasive evidence that an arrangement exists, title and risk of loss have passed, delivery has occurred or the services have been rendered, the sales price is fixed or determinable and collection of the related receivable is reasonably assured. Title and risk of loss generally pass to our customers upon shipment. In limited circumstances where either title or risk of loss pass upon destination or acceptance or when collection is *not* reasonably assured, we defer revenue recognition until such events occur. In general, customers are allowed to return the product, free of penalty, within *thirty* days of shipment, if the product does *not* conform to its specifications.

We record an allowance for estimated sales returns based on past experience and current knowledge of our customer base. Our experience has been such that only a very small percentage of products are returned. Should our experience change, however, we *may* require additional allowances for sales returns.

Revenue for established products that have previously satisfied a customer's acceptance requirements and provide for full payment tied to shipment is generally recognized upon shipment and passage of title. In limited cases where a prior history of customer acceptance cannot be demonstrated or sales where customer payment dates are *not* determinable or when collection is *not* reasonably assured, revenue is deferred until customer acceptance occurs or payment has been received. On the limited shipments where sales are *not* recognized, gross profit is generally recorded as deferred profit in our balance sheet representing the difference between the receivable recorded and the inventory shipped.

At *December 31, 2017,* we had deferred revenue of approximately *$927,000* and *no* deferred profit. At *December 31, 2016,* we had deferred revenue of approximately *$892,000* and *no* deferred profit.

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 *December 31, 2017* and *2016, $100,000* is restricted for use as collateral for the Company's credit cards.

Concentration of Credit Risk, Other Concentration Risks and Significant Customers

Qualstar sells its products primarily through value added resellers located worldwide. Ongoing credit evaluations of customers' financial condition are performed by Qualstar, and generally, collateral is *not* required. Potential uncollectible accounts have been provided for in the financial statements.

We are exposed to foreign currency and interest rate risks. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since all of our investments are in US fixed income securities. 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. Sales outside North America represented approximately *37.7%* of net revenues for the *twelve* months ended *December 31, 2017* and *46.1%* of net revenues for the *twelve* months ended *December 31, 2016.*

Revenues from Qualstar's largest customer totaled approximately *13.2%* and *10.6%* of revenues for the *twelve* months ended *December 31, 2017* and *2016,* respectively. At *December 31, 2017,* the largest customer's accounts receivable balance, net of specific allowances, totaled approximately *9.3%* of net accounts receivable. At *December 31, 2016,* the largest customer's accounts receivable balance, net of specific allowances, totaled approximately *22.3%* of net accounts receivable.

Suppliers

The primary suppliers of our power supplies segment, *N2Power,* are located in China. The primary suppliers of our tape storage products are located in California and Germany. If a manufacturer should be unable to deliver products to us in a timely basis or at all, our power supply or data storage business 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.

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. Activity in the allowance for doubtful accounts was as follows (in thousands):

Description	**Balance at Beginning of Period**	**Charged to Costs and Expenses**	**Charged to Other Accounts**	**Deductions (1)**	**Balance at End of Period**
Twelve months ended December 31, 2017	$ *61*	$ *3*	$ —	$ *(10*)	$ *54*
Twelve months ended December 31, 2016	$ *99*	$ *(38*)	$ —	$ —	$ *61*

(*1*) Uncollectible accounts written off, net of recoveries.

Inventories, net

Inventories are stated at the lower of cost 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 (in years)	*5 - 7*
Furniture and fixtures (in years)	*5 - 7*
Leasehold Improvements (in years)	*3 - 5*
Computer equipment (in years)	*3 - 5*

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 reviews the impairment of long-lived assets 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.

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.

Warranty Obligations

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 onsite 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. Customers *may* purchase extended advance replacement service coverage and on-site service if they are located in the United States, Canada and most countries within Europe.

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

	December 31,	
	2017	**2016**
Beginning balance	$*236*	$*187*
Cost of warranty claims	*(37*)	*(157*)
Accruals for product warranties	*123*	*206*
Ending balance	$*322*	$*236*

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, and 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. Advertising and promotion expenses for the years ended *December 31, 2017* and *2016* were approximately *$49,000* and *$73,000,* respectively.

Fair Value Measurements

We determine fair value measurements based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, we follow the following fair value hierarchy that distinguishes between (*1*) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (*2*) our own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs):

Level *1:* Observable inputs such as quoted prices for identical assets or liabilities in active markets;

Level *2:* Other inputs observable directly or indirectly, such as quoted prices for similar assets or liabilities or market-corroborated inputs; and

Level *3:* Unobservable inputs for which there is little or *no* market data and which requires the owner of the assets or liabilities to develop its own assumptions about how market participants would price these assets or liabilities.

Our assessment of the significance of a particular input to the fair value measurement requires judgment and *may* affect the valuation of assets and liabilities and their placement within the fair value hierarchy.

The following table presents our cash and cash equivalents and restricted cash measured at fair value on a recurring basis at *December 31, 2017* and *2016* (in thousands):

	December 31, 2017				
	Adjusted Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**	**Cash & Cash Equivalents**
Level 1:					
Cash	$*4,698*	$ -	$ -	$*4,698*	$ *4,698*
Restricted Cash	*100*	-	-	*100*	*100*
Total	$*4,798*	$ -	$ -	$*4,798*	$ *4,798*

	December 31, 2016				
	Adjusted Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**	**Cash & Cash Equivalents**
Level 1:					
Cash	$*3,691*	$ -	$ -	$*3,691*	$ *3,691*
Restricted Cash	*100*	-	-	*100*	*100*
Total	$*3,791*	$ -	$ -	$*3,791*	$ *3,791*

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 (vesting can be immediate or over a period of *four* years) of the stock award using the straight-line method.

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.

Comprehensive Income (Loss)

Comprehensive income (loss) includes unrealized gains and losses on debt and equity securities classified as available-for-sale and included as a component of shareholders' equity.

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.

Shares issuable under stock options of *188,033* and *23,333* as of *December 31, 2017* and *2016* respectively, have been excluded from the computation of diluted income per share as the effect would be antidilutive.

Recent Accounting Guidance

Recent accounting guidance not yet adopted

In *May 2014,* the FASB issued ASU *No. 2014-09,* “Revenue from Contracts with Customers (Topic *606*)” (ASU *2014-09*) as modified by ASU *No. 2015-14,* to defer the effective date, and ASU *2016-08,* principal versus agent considerations (Reporting Revenue Gross versus Net), and ASU *No. 2016-10,* identifying performance obligations and licensing, and ASU *No. 2016-12,* narrow-scope improvements and practical expedients. The revenue recognition principle in ASU *2014-09* is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, new and enhanced disclosures will be required. Companies *may* adopt the new standard either using the full retrospective approach, a modified retrospective approach with practical expedients, or a cumulative effect upon adoption approach. This standard is effective for fiscal years beginning after *December 15, 2017.* The Company will adopt the new standard effective *January 1, 2018,* using the full retrospective approach. The adoption of ASU *2014-09* will *not* have a material impact on the Company’s consolidated financial statements.

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

In *August 2016,* the FASB issued ASU *2016-15* to reduce the existing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This standard is effective for fiscal years beginning after *December 15, 2017* and is *not* expected to materially impact our consolidated financial statements.

In *October 2016,* the FASB issued ASU *2016-16* to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. This standard is effective for fiscal years beginning after *December 15, 2017* and is *not* expected to materially impact our consolidated financial statements.

In *January 2017,* the FASB issued ASU *2017-01* clarifying the definition of a business and adding guidance to evaluate whether transactions should be accounted for as acquisitions or disposals of assets or businesses. This standard is effective for fiscal years beginning after *December 15, 2017* and is *not* expected to materially impact our consolidated financial statements.

In *May 2017,* the FASB issued ASU *2017-09* to provide clarity and reduce both diversity in practice and cost and complexity, when applying the guidance for stock compensation, to a change to the terms or conditions of a share-based payment award. This standard is effective for fiscal years beginning after *December 15, 2017* and is *not* expected to materially impact our consolidated financial statements.

Recent accounting guidance adopted

In *July 2015,* the FASB issued ASU *2015-11* to simplify the measurement of inventory. The objective is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. Effective *January 1, 2017,* the Company adopted ASU *2015-11* and it did *not* have a material effect on our consolidated financial statements.

Note *2* – Inventories, net

Inventories consist of the following, in thousands:

	December 31, 2017	**December 31, 2016**
Raw materials	$ *55*	$ *45*
Finished goods	*1,509*	*1,315*
Inventories, net	$ *1,564*	$ *1,360*

Note *3* – Property and Equipment, net

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

	December 31, 2017	December 31, 2016
Leasehold improvements	$ *114*	$ *114*
Furniture and fixtures	*268*	*314*
Machinery and equipment	*842*	*1,039*
Total property and equipment	*1,224*	*1,467*
Less accumulated depreciation and amortization	*(1,052*)	*(1,181*)
Property and equipment, net	$ *172*	$ *286*

Depreciation and amortization expense for the year ended *December 31, 2017* and *2016* was *$154,000, $182,000,* respectively.

Note *4* – Accrued Payroll and Related Liabilities

The components of accrued payroll and related liabilities are as follows, in thousands:

	December 31, 2017	December 31, 2016
Accrued salaries and payroll taxes	$ *59*	$ *62*
Accrued vacation	*114*	*120*

Accrued bonuses	-	*40*
Total accrued payroll and related liabilities	$ *173*	$ *222*

Note *5* – Other Accrued Liabilities

The components of other accrued liabilities are as follows, in thousands:

	December 31, 2017	**December 31, 2016**
Accrued warranty	$ *322*	$ *236*
Accrued outside commissions	*69*	*28*
Accrued contingent legal fees	-	*25*
Accrued deferred rent	*29*	*37*
Other accrued liabilities	*34*	*33*
Total other accrued liabilities	$ *454*	$ *359*

Note *6* – Income Taxes

The provision for (benefit from) income taxes is comprised of the following, in thousands:

	December 31, 2017	December 31, 2016
Current:		
Federal (Net of a net operating loss benefit of $356)	$ —	$ —
State (Net of a net operating loss benefit of $82)	*13*	—
Foreign	*4*	—
	17	—
Deferred:		
Federal	—	—
State	—	—
	$ —	$ —
	$ *17*	$ —

The following is a reconciliation of the statutory federal income tax rate to Qualstar's effective income tax rate:

	Twelve Months Ended December 31, 2017	2016
Statutory federal income tax benefit	*34.0* %	*(34.0)*%
State income taxes, net of federal income tax benefit	*13.6*	*8.7*
Foreign income taxes, net of federal income tax benefit	*6.4*	*(1.3*)
Engineering credits	*3.4*	*(5.2*)
Tax effect of change in federal tax rate (from 34% to 21%)	*649.5*	
Valuation allowance	*(712.0*)	*26.2*
Other	*7.8*	*5.6*
Effective federal income tax rate	*2.7* %	*0.0* %

The tax effect of temporary differences resulted in deferred income tax assets (liabilities) as follows:

	December 31, 2017	December 31, 2016
Deferred tax assets:		