QUALSTAR CORP
Form 10-Q
November 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

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)

(805) 583-7744

(Registrant's telephone number, including area code)

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 every Interactive Data File required to be submitted 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 such files). Yes No

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 the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and emerging growth company in Rule 12b-2 of the Exchange Act.

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 Exchange Act). Yes   No

At November 1, 2018 the issuer had 2,048,118 shares of common stock, no par value, issued and outstanding.

QUALSTAR CORPORATION

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2018

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PART I — FINANCIAL INFORMATION

ITEM 1. Financial Statements

QUALSTAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	September 30, 2018 (Unaudited)	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$ 4,831	$ 4,698
Restricted cash	100	100
Accounts receivables, net	2,046	1,802
Inventories, net	2,718	1,564
Prepaid expenses and other current assets	188	163
Total current assets	9,883	8,327
Non-current assets:		
Property and equipment, net	120	172
Other assets	119	68
Total assets	$ 10,122	$ 8,567
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 1,082	$ 1,065
Accrued payroll and related liabilities	326	173
Deferred service revenue, short-term	710	834
Other accrued liabilities	453	454
Total current liabilities	2,571	2,526
Long-term liabilities:		
Other long-term liabilities	39	52

Deferred service revenue	108	93
Total long-term liabilities	147	145
Total liabilities	2,718	2,671
Shareholders’ equity:		
Preferred stock, no par value; 5,000,000 shares authorized; no shares issued	-	-
Common stock, no par value; 50,000,000 shares authorized, shares issued and outstanding 2,048,118 at September 30, 2018 and 2,042,019 shares at December 31, 2017	19,519	19,480
Accumulated deficit	(12,115)	(13,584)
Total shareholders’ equity	7,404	5,896
Total liabilities and shareholders’ equity	$ 10,122	$ 8,567

See notes to condensed consolidated financial statements.

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QUALSTAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net revenues	$3,154	$2,755	$9,320	$7,461
Cost of goods sold	1,901	1,697	5,217	4,616
Gross profit	1,253	1,058	4,103	2,845
Operating expenses:				
Engineering	123	131	372	427
Sales and marketing	351	360	1,000	886
General and administrative	374	715	1,262	1,563
Total operating expenses	848	1,206	2,634	2,876
Income (loss) from operations	405	(148)	1,469	(31)
Other expenses	-	-	-	-
Income (loss) before income taxes	405	(148)	1,469	(31)
Provision for income taxes	-	-	-	-
Net income (loss)	$405	$(148)	$1,469	$(31)
Earnings (loss) per share:				
Basic	$0.20	$(0.07)	$0.72	$(0.02)
Diluted	$0.20	$(0.07)	$0.70	$(0.02)
Shares used in per share calculation:				
Basic	2,048	2,042	2,048	2,042
Diluted	2,065	2,042	2,088	2,042

See notes to condensed consolidated financial statements.

QUALSTAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Nine months Ended September 30, 2018	2017
Cash flows from operating activities:		
Net income (loss)	$1,469	$(31)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	69	119
Loss on disposal of assets	-	5
Provision for recovery of bad debts and returns, net	1	(7)
Provision for inventory obsolescence	227	233
Share based compensation	-	413
Changes in operating assets and liabilities:		
Accounts receivable	(245)	137
Inventories	(1,381)	45
Prepaid expenses and other current assets	(75)	2
Accounts payable	17	14
Accrued payroll and related liabilities	153	(16)
Deferred service revenue	(109)	60
Other accrued liabilities	(14)	8
Total adjustments	(1,357)	1,013
Net cash provided by operating activities	112	982
Cash flows from investing activities:		
Purchases of equipment	(18)	(10)
Net cash used in investing activities	(18)	(10)
Cash flows from financing activities:		
Proceeds from the exercise of stock options	39	-
Net cash provided by financing activities	39	-
Net increase in cash, restricted cash and cash equivalents	133	972
Cash, restricted cash and cash equivalents at beginning of period	4,798	3,791
Cash, restricted cash and cash equivalents at end of period	$4,931	$4,763
Supplemental cash flow disclosures:		

Income taxes paid	$32	$3

See notes to condensed consolidated financial statements.

QUALSTAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated balance sheet as of December 31, 2017, has been derived from audited consolidated financial statements. The accompanying unaudited interim condensed consolidated financial statements have been prepared on the same basis as our annual audited consolidated financial statements and in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial statements.

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

On June 5, 2017, a wholly-owned subsidiary of Qualstar Corporation, N2Power, Inc., was created to operate the Company’s internal business unit known as N2Power. The N2Power business unit is reflected in the Company’s SEC filings under the power supplies business segment. Following the establishment of N2Power, Inc., all assets (and liabilities) associated with the N2Power business were assigned to the newly created entity.

On July 4, 2018, a wholly-owned subsidiary of Qualstar Corporation, Qualstar Limited, was created to operate the Company’s data storage business in Europe and Africa.

On September 5, 2018, a wholly-owned subsidiary of Qualstar Corporation, Q-Smart Data Private Limited, was created to operate the Company's data storage business in Asia.

The Company's significant accounting policies are disclosed in Note 2 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 16, 2018 (the "Annual Report"). There were no material changes to the significant accounting policies during the nine months ended September 30, 2018, apart from the Company's accounting policy related to revenue recognition, as discussed below.

Effective January 1, 2018, the Company adopted Accounting Standards Codification ("ASC") 606, *Revenue from Contracts with Customers* ("ASC 606" or the "New Revenue Standard"), the new standard on revenue from contracts with customers, which codified Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers* ("ASU 2014-09"). As a result, the Company changed its accounting policy for revenue recognition to ensure compliance with ASC 606 as described below.

Principles of Consolidation

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

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with information included in the Company's Annual Report.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

Revenue Recognition

Effective January 1, 2018, we adopted Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers* (ASC 606), and we determined that the new guidance had no material impact to the revenue recognized prior to January 1, 2018 and, had no impact on retained earnings as of January 1, 2018. Accordingly, the adoption of ASC 606 had no impact on the Company's financial position, results of operations or liquidity. This standard applies to all contracts with customers, except for contracts that are within the scope of other standards, such as leases and financial instruments. Under ASC 606, the Company recognizes revenue when its customer obtains control of promised goods or services, in an amount that reflects the consideration which we expect to receive in exchange for those goods or services. To determine revenue recognition for arrangements that the Company determines are within the scope of ASC 606, we perform the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) we satisfy a performance obligation. The five-step model is applied to contracts when it is probable that we will collect the consideration we are entitled to in exchange for the goods or services transferred to the customer. At contract inception, once the contract is determined to be within the scope of ASC 606, we assess the goods or services promised within each contract and determine those that are performance obligations and assess whether each promised good or service is distinct. We then recognize revenue in the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied.

Furthermore, 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. We derive revenues from two primary sources: products and services. Product revenue includes the shipment of product according to the agreement with our customers for data storage products and power supplies. Services include customer support (technical support), installations, consulting, and design services. A contract may include both product and services. Rarely, contracts with customers contain multiple performance obligations. For these contracts, the Company accounts for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. Standalone selling prices are typically estimated based on observable transactions when these services are sold on a standalone basis.

We provide product warranties with varying lengths of time and terms. The product warranties are considered to be assurance-type in nature and do not cover anything beyond ensuring that the product is functioning as intended. Based on the guidance in ASC 606, assurance-type warranties do not represent separate performance obligations. We also sell separately-priced maintenance service contracts which qualify as service-type warranties and represent separate performance obligations. We have historically experienced a low rate of product returns under the warranty program.

A variety of technical services can be contracted by our customers for a designated period of time. The service contracts allow customers to call Qualstar for technical support, replace defective parts and to have onsite service provided by Qualstar’s third party contract service provider. We record revenue for contract services at the amount of the service contract, but such amount is deferred at the beginning of the service term and amortized ratably over the life of the contract.

Our professional services include consulting, engineer and design services. Because control transfers over time, revenue is recognized based on progress toward completion of the performance obligation. The method to measure progress toward completion requires judgment and is based on the nature of the products or services to be provided. The Company generally uses the input method to measure progress for its contracts because it best depicts the transfer of assets to the customer, which occurs as the Company incurs costs for the contracts. Under the cost-to-cost measure of progress, the progress toward completion is measured based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. Revenue is recorded proportionally as costs are incurred. Costs to fulfill these obligations include labor and subcontractor costs.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

Deferred service revenue is shown separately in the condensed consolidated balance sheets as current and long term. At September 30, 2018 we had deferred service revenue of approximately $818,000. At December 31, 2017, we had deferred service revenue of approximately $927,000.

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. When legal costs that the entity expects to incur in defending itself in connection with a loss contingency accrual are expected to be material, the loss should factor in all costs and, if the legal costs are reasonably estimable, they should be accrued in accordance with ASC 450, regardless of whether a liability can be estimated for the contingency itself. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. Changes in these factors could materially impact our condensed consolidated financial statements.

Fair Value of Financial Instruments

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

Accounting for Income Taxes

We estimate our tax liabilities based on current tax laws in the statutory jurisdictions in which we operate in accordance with ASC 740, “Income Taxes.” 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 derecognition 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.

Operating Segments

The Company operates in two segments, as the chief operating decision maker makes decisions and assesses performance at the divisional level. Operating segments are identified as components of an enterprise about which separate discrete financial information is utilized for evaluation by the chief operating decision maker in making decisions regarding resource allocation and assessing performance. To date, the chief operating decision maker has made such decisions and assessed performance at the two divisional levels. The Company's chief operating decision maker is its President and Chief Executive Officer.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

Recent accounting guidance not yet adopted

In July 2018, the FASB issued ASU 2018-10 and 2018-11 to provide additional guidance related to accounting for leases, such as the application of an implicit rate, lessee reassessment of lease classification and certain transition adjustments. This standard is effective for fiscal years beginning after December 15, 2018. We are evaluating the impact of ASU 2018-10 and 2018-11 may have on our condensed consolidated financial statements.

In July 2018, the FASB issued ASU 2018-09, “Codification Improvements”. This ASU makes changes to a variety of topics to provide clarification and correction of errors to the Accounting Standards Codification. The majority of the amendments in ASU 2018-09 are effective for the Company after December 15, 2018. We are evaluating the impact ASU 2018-09 may have on our condensed consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07 as a simplification for the accounting for nonemployee share-based payment transactions resulting from expanding the scope of Topic 718, Compensation-Stock Compensation. This standard is effective for fiscal years beginning after December 15, 2018. We are evaluating the impact ASU 2018-07 may have on our condensed consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02 to provide guidance related to adjustments for deferred tax assets and liabilities based on the changes created by the U.S. federal government tax bill enacted December 22, 2017. This standard is effective for fiscal years beginning after December 15, 2018. We are evaluating the impact ASU 2018-02 may have on our condensed 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. The FASB has also issued ASU 2018-10 to narrow aspects of the guidance in 2016-02, with the same effective date. This standard is effective for fiscal years beginning after December 15, 2018. We are evaluating the impact ASU 2016-02 may have on our condensed consolidated financial statements.

NOTE 3 – SIGNIFICANT CUSTOMERS, CONCENTRATION OF CREDIT RISK, AND GEOGRAPHIC INFORMATION

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

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

	Three Months Ended				**Nine months Ended**			
	September 30, 2018		**2017**		**September 30, 2018**		**2017**	
Revenue – geographic activity (in thousands):	**(unaudited)**		**(unaudited)**		**(unaudited)**		**(unaudited)**	
	$	**%**	**$**	**%**	**$**	**%**	**$**	**%**
North America	$1,723	54.6 %	$1,962	71.2 %	$5,082	54.5 %	$4,785	64.1 %
Europe	545	17.3 %	356	12.9 %	1,427	15.3 %	1,447	19.4 %
Asia Pacific	883	28.0 %	396	14.4 %	2,769	29.7 %	1,113	14.9 %
Other	3	0.1 %	41	1.5 %	42	0.5 %	116	1.6 %
	$3,154	100.0%	$2,755	100.0%	$9,320	100.0%	$7,461	100.0%

QUALSTAR CORPORATION AND SUBSIDIARIES

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

Three customers accounted for 12.1%, 11.1% and 10.7% of the Company's net revenue for the three-month period ended September 30, 2018. At September 30, 2018, the same three customers were 60.0% of the accounts receivable balance. One customer accounted for 14.6% of the Company's net revenue for the three-month period ended September 30, 2017. At December 31, 2017, two of the customers from September 30, 2018 represented 31.1% of the total accounts receivable balance.

One customer accounted for 12.3% of the Company's net revenue for the nine-month period ended September 30, 2018. A different customer accounted for 15.0% of the Company's net revenue for the nine-month period ended September 30, 2017.

NOTE 4 – NET EARNINGS PER SHARE

Basic net earnings per share has been computed by dividing net income or loss by the weighted average number of common shares outstanding. Diluted net earnings per share has been computed by dividing net earnings by the weighted average common shares outstanding plus dilutive securities or other contracts to issue common stock as if these securities were exercised or converted to common stock.

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

	Three Months Ended		Nine months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
In thousands (except per share amounts):				
Net income (loss) (a)	$405	$(148)	$1,469	$(31)

Weighted average outstanding shares of common stock (b)	2,048	2,042	2,048	2,042
Dilutive potential common shares from employee stock options	17	—	40	—
Common stock and common stock equivalents (c)	2,065	2,042	2,088	2,042
Income per share:				
Basic net income (loss) per share (a)/(b)	$0.20	$(0.07)	$0.72	$(0.02)
Diluted net income (loss) per share (a)/(c)	$0.20	$(0.07)	$0.70	$(0.02)

For the three and nine months ended September 30, 2018, 1,333 and 188,633 outstanding stock options were excluded from the calculation of diluted net income per share as their inclusion would have been anti-dilutive.

NOTE 5 - BALANCE SHEET DETAILS

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

Inventories

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

	September 30, 2018 (unaudited)	**December 31, 2017**
Raw materials	$ 174	$ 55
Finished goods	2,544	1,509
Net inventory balance	$ 2,718	$ 1,564

QUALSTAR CORPORATION AND SUBSIDIARIES

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

Property and equipment, net

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

	September 30, 2018 (unaudited)	**December 31, 2017**
Leasehold improvements	$ 114	$ 114
Furniture and fixtures	286	268
Machinery and equipment	836	842
	1,236	1,224
Less accumulated depreciation and amortization	(1,116)	(1,052)
Property and equipment, net	$ 120	$ 172

Depreciation and amortization expense for the three months ended September 30, 2018 and 2017 was $17,000 and $36,000 (unaudited), respectively, and for the nine months ended September 30, 2018 and 2017 was $69,000 and $119,000 (unaudited), respectively.

Other Accrued Liabilities

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

	September 30, 2018 (unaudited)	**December 31, 2017**
Accrued warranty	$ 372	$ 322
Accrued outside commissions	48	69

Deferred rent	24	29
Other accrued liabilities	9	34
Total other accrued liabilities	$ 453	$ 454

NOTE 6 –CONTINGENCIES

Accrued Warranty

We provide for the estimated costs of hardware warranties at the time the related revenue is recognized. We estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions for tape libraries generally include parts and labor over a three-year period. The warranty for power supplies is generally three years. We regularly re-evaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

Activity in the liability for product warranty, which is included in other accrued liabilities in the condensed consolidated balance sheets for the periods presented, is as follows (in thousands):

	Nine months Ended September 30, 2018 (unaudited)	Year Ended December 31, 2017
Beginning balance	$ 322	$ 236
Cost of warranty claims	(13)	(37)
Accruals for product warranties	63	123
Ending balance	$ 372	$ 322

NOTE 7 –COMMITMENTS

Lease Agreements

Qualstar leases a 15,160 square foot facility located in Simi Valley, California. The three-year lease began December 15, 2014 and has been renewed for an additional three years, expiring February 28, 2021. Rent on this facility is $11,000 per month with a step-up of 3% annually. Qualstar subleases a portion of the warehouse space to Interlink Electronics, Inc. (“Interlink”) and is reimbursed for the space and other related expenses on a monthly basis. As described in Note 11, Interlink is a related party.

Qualstar also leases approximately 5,400 square feet of office space in Westlake Village, California, that expires January 31, 2020. Rent on this facility is $11,000 per month, with a step-up of 3% annually. Effective March 21, 2016, Qualstar entered into a sublease agreement for the Westlake Village facility. The term of the sublease expires at the same time as the term of the master lease and the tenant pays Qualstar $12,000 per month with a step-up of 3% annually.

Effective April 1, 2016, a two-year lease was signed for 1,359 square feet for $2,500 per month in Singapore, which has been renewed until June 30, 2019.

The Company provides for rent expense on a straight-line basis over the lease terms.

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

Years Ending December 31,	**Minimum Lease Payment**	**Sublease Revenue**	**Net Minimum Lease Payment**
Remainder of 2018	$ 73	(36)	$ 37
2019	274	(147)	127
2020	147	(12)	135
2021	23	-	23
Total Commitment	$ 517	$ (195)	$ 322

Net rent expense for the three months ended September 30, 2018 and 2017 was $37,000 and $36,000, respectively and for the nine months ended September 30, 2018 and 2017 was $113,000 and $107,000, respectively.

QUALSTAR CORPORATION AND SUBSIDIARIES

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

NOTE 8 –STOCK INCENTIVE PLANS AND SHARE-BASED COMPENSATION

Share-Based Compensation

The Company did not incur an expense for share-based compensation associated with outstanding stock options for the nine months ended September 30, 2018 and 2017. No income tax benefit was recognized in the condensed consolidated statements of operations for share-based arrangements in any period presented. At September 30, 2018, the Company did not have any unrecognized compensation costs related to share-based compensation.

Stock Option Plan

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

Qualstar adopted the 2008 Stock Incentive Plan (the “2008 Plan”) under which incentive and nonqualified stock options and restricted stock could be granted for shares of common stock. The 2008 Plan has expired and no additional options may be granted under that plan. However, 20,000 options that were previously granted under the 2008 Plan will continue under their terms.

The 2017 Stock Incentive Plan (the “2017 Plan”) was approved by Qualstar shareholders on June 13, 2017. The 2017 Plan, permits the award of stock options (both incentive and non-qualified options), stock appreciation rights, restricted stock, restricted stock units, unrestricted stock, performance shares, dividend equivalent rights and cash-based awards to employees (including executive officers), directors and consultants of the Company and its subsidiaries. The 2017 Plan authorizes the issuance of an aggregate of 200,000 shares of common stock and the plan is administered by the Compensation Committee of the Company’s Board of Directors.

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

The following table summarizes stock option activity:

Options	**Shares**	**Weighted Average Exercise Price per Share**	**Weighted Average Remaining Contractual Term (years)**	**Aggregate Intrinsic Value**
Outstanding at December 31, 2017	188,033	$ 7.38		