

QUALSTAR CORP
Form 10-Q
May 13, 2014

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the Quarterly Period March 31, 2014

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 000-30083

QUALSTAR CORPORATION

CALIFORNIA

95-3927330

(State of incorporation)

(I.R.S. Employer
Identification No.)

3990-B Heritage Oak Court, Simi Valley, CA 93063

(805) 583-7744

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 website, 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|-------------------------|-------------------|-----------------------|---------------------------|
| Large accelerated filer | Accelerated filer | Non-accelerated filer | Smaller reporting company |
|-------------------------|-------------------|-----------------------|---------------------------|

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

Total shares of common stock without par value outstanding at May 13, 2014 are 12,253,117.

QUALSTAR CORPORATION

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2014

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PART I — FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****QUALSTAR CORPORATION****CONDENSED BALANCE SHEETS****(In thousands)**

| | March 31, | June 30, |
|--|--------------------|------------------|
| | 2014 | 2013 |
| | (Unaudited) | (Audited) |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 4,823 | \$ 1,966 |
| Marketable securities, short-term | 2,718 | 6,305 |
| Receivables, net of allowances of \$117 at March 31, 2014, and \$68 at June 30, 2013 | 1,728 | 3,140 |
| Receivable from CTS for manufacturing inventories, net of allowance of \$0 at March 31, 2014, and \$203 at June 30, 2013 | - | 644 |
| Inventories | 3,427 | 1,628 |
| Prepaid expenses and other current assets | 281 | 363 |
| Total current assets | \$ 12,977 | \$ 14,046 |
| Property and equipment, net | 557 | 545 |
| Marketable securities, long-term | 199 | 5,546 |
| Other assets | 79 | 70 |
| Total assets | \$ 13,812 | \$ 20,207 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 904 | \$ 2,089 |
| Accrued payroll and related liabilities | 235 | 424 |
| Deferred service revenue | 1,248 | 953 |
| Other accrued liabilities | 1,617 | 1,979 |
| Total current liabilities | \$ 4,004 | \$ 5,445 |
| Other long term liabilities | 17 | 17 |
| Commitments and contingencies | | |

Shareholders' equity:

| | | |
|---|-----------|-----------|
| Preferred stock, no par value; 5,000 shares authorized; no shares issued | - | - |
| Common stock, no par value; 50,000 shares authorized, 12,253 shares issued and outstanding as of March 31, 2014 and June 30, 2013 | 18,932 | 18,938 |
| Accumulated other comprehensive income | 3 | 4 |
| Accumulated deficit | (9,144) | (4,197) |
| Total shareholders' equity | \$ 9,791 | \$ 14,745 |
| Total liabilities and shareholders' equity | \$ 13,812 | \$ 20,207 |

See notes to condensed financial statements.

QUALSTAR CORPORATION**CONDENSED STATEMENTS OF COMPREHENSIVE LOSS****(Unaudited)****(In thousands, except per share data)**

| | Three Months Ended | | Nine Months Ended | |
|--|-------------------------------|-------------|------------------------------|-------------|
| | March 31, | | March 31, | |
| | 2014 | 2013 | 2014 | 2013 |
| Net revenues | \$2,562 | 2,952 | \$8,192 | 9,760 |
| Cost of goods sold | 2,761 | 2,080 | 6,422 | 6,675 |
| Gross profit (loss) | \$(199) | \$872 | \$1,770 | \$3,085 |
| Operating expenses: | | | | |
| Engineering | 501 | 854 | 1,979 | 2,262 |
| Sales and marketing | 484 | 846 | 1,728 | 2,181 |
| General and administrative | 992 | 1,576 | 3,009 | 3,235 |
| Restructuring expense | - | 913 | 26 | 2,306 |
| Total operating expenses | \$1,977 | \$4,189 | \$6,742 | \$9,984 |
| Loss from operations | (2,176) | (3,317) | (4,972) | (6,899) |
| Other income (expense) | 7 | 16 | 25 | (21) |
| Loss before income taxes | (2,169) | (3,301) | (4,947) | (6,920) |
| Provision for income taxes | - | - | - | - |
| Net loss | \$(2,169) | \$(3,301) | \$(4,947) | \$(6,920) |
| Change in unrealized (losses) gains on investments | (7) | 9 | (1) | 14 |
| Comprehensive loss | \$(2,176) | (3,292) | \$(4,948) | (6,906) |
| Loss per common share: | | | | |
| Basic and Diluted | \$(0.18) | \$(0.27) | \$(0.40) | \$(0.56) |
| Weighted average common shares outstanding: | | | | |
| Basic and Diluted | 12,253 | 12,253 | 12,253 | 12,253 |

See notes to condensed financial statements.

QUALSTAR CORPORATION**CONDENSED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

| | Nine Months Ended | |
|---|------------------------------|----------------|
| | March 31, 2014 | 2013 |
| OPERATING ACTIVITIES: | | |
| Net loss | \$(4,947) | (6,920) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 136 | 136 |
| Loss on disposal of assets | 4 | - |
| Provision for bad debts and returns, net | 49 | 7 |
| Provision for inventory reserve and adjustments | 1,794 | 341 |
| Stock based compensation | (6) | 44 |
| Loss on sale of marketable securities | - | 47 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,007 | (437) |
| Inventories | (3,593) | 1,549 |
| Prepaid expenses and other assets | 73 | (77) |
| Accounts payable | (1,185) | (247) |
| Accrued payroll and related liabilities | (189) | 345 |
| Deferred service revenue | 295 | 454 |
| Other accrued liabilities | (362) | 1,016 |
| Total adjustments | (977) | 3,178 |
| Net cash used in operating activities | \$(5,924) | (3,742) |
| INVESTING ACTIVITIES: | | |
| Purchases of equipment | (146) | (366) |
| Purchases of marketable securities | - | (9,432) |
| Proceeds from the sale of marketable securities | 8,927 | 6,984 |
| Net cash provided by (used in) investing activities | \$8,781 | (2,814) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | \$2,857 | (6,556) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | \$1,966 | 7,381 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$4,823 | 825 |
| SUPPLEMENTAL CASH FLOW DISCLOSURES: | | |
| Income taxes paid | \$2 | 10 |

See notes to condensed financial statements.

QUALSTAR CORPORATION

CONDENSED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

NINE MONTHS ENDED MARCH 31, 2014

(Unaudited)

(In thousands)

| | Accumulated | | | | |
|---|---------------------|---------------|---------------|--------------------|--------------|
| | Common Stock | | Other | Accumulated | |
| | Shares | Amount | Income | Deficit | Total |
| Balance at June 30, 2013 | 12,253 | \$ 18,938 | \$ 4 | \$ (4,197) |) \$ 14,745 |
| Share-based compensation | | (6) | | | (6) |
| Comprehensive loss: | | | | | |
| Change in unrealized gains on investments | | | (1) | | (1) |
| Net loss | | | | (4,947) |) (4,947) |
| Comprehensive loss | | | | | (4,948) |
| Balance at March 31, 2014 | 12,253 | \$ 18,932 | \$ 3 | \$ (9,144) |) \$ 9,791 |

See notes to condensed financial statements.

QUALSTAR CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS (Unaudited)

Note 1 – Summary of Significant Accounting Policies

Basis of Presentation

In the opinion of management, the accompanying unaudited condensed financial statements, including balance sheets and related interim statements of comprehensive loss, cash flows, and shareholders' equity, include all adjustments, consisting primarily of normal recurring items, which are necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP").

Preparing 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.

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 Qualstar Corporation Annual Report on Form 10-K for the fiscal year ended June 30, 2013, filed with the U.S. Securities and Exchange Commission ("SEC") on September 30, 2013.

Risks and Uncertainties

We are subject to a number of risks and uncertainties that may significantly impact our future operating results. These risks and uncertainties are discussed under Part II, Item 1A, "Risk Factors" included in this Form 10-Q. As our interim description of risks and uncertainties only includes any material changes to our annual description, we refer you to our

risk factors previously disclosed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended June 30, 2013, as filed with the SEC.

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.

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 consolidated balance sheet representing the difference between the receivable recorded and the inventory shipped.

Deferred revenue is shown separately in the balance sheet, and deferred profit is included in other accrued liabilities in the balance sheet. At March 31, 2014, we had deferred revenue of approximately \$1,248,000, and deferred profit of approximately \$59,000. At June 30, 2013, we had deferred revenue of approximately \$953,000 and deferred profit of approximately \$209,000.

Marketable Securities

Marketable securities consist primarily of high-quality U.S. corporate securities, U.S. federal government debt securities, corporate and municipal bonds. Our marketable securities portfolio consists of short-term securities with original maturities of greater than three months from the date of purchase and remaining maturities of less than one year and long-term securities with original maturities of greater than one year and less than five years. Marketable securities are classified as "available-for-sale" and are recorded at fair value using the specific identification method; unrealized gains and losses are reflected in other comprehensive income until realized; realized gains and losses are included in earnings when the underlying securities are sold and are derived using the specific identification method for determining the cost of securities sold. If the credit ratings of the security issuers deteriorate or if market conditions deteriorate, we may be required to reduce the value of our investments through an impairment charge.

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 financial statements on a recurring basis (at least quarterly). See “Note 5 – Fair Value Measurements.”

QUALSTAR CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS- (Continued)

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. 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 estimates; 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 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 financial statements. We have accrued \$337,000 for such contingencies.

Share-Based Compensation

Share-based compensation is accounted for in accordance with ASC 718, "Compensation – Stock Compensation." 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 amount 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 impacted.

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.

QUALSTAR CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS- (Continued)

Note 2 – Recent Accounting Pronouncements

Recently adopted accounting guidance

On July 1, 2013, we adopted ASU 2013-02 guidance on disclosure requirements for items reclassified out of accumulated other comprehensive income. This new guidance requires entities to present (either on the face of the income statement or in the notes) the effects on the line items of the income statements for amounts reclassified out of accumulated other comprehensive income. Adoption of this new guidance did not impact our financial statements.

On July 1, 2013, we adopted ASU 2012-02 guidance on testing indefinite-lived intangible assets for impairment. The new guidance provides an entity with the option to first assess qualitative factors to determine whether it is necessary to perform a quantitative impairment test, simplifying the guidance for testing the decline in the realizable value (impairment) of indefinite-lived intangible assets other than goodwill. Examples of intangible assets subject to the guidance include indefinite-lived trademarks, licenses, and distribution rights. An organization electing to perform a qualitative assessment is no longer required to calculate the fair value of an indefinite-lived intangible asset unless the organization determines, based on a qualitative assessment, that it is “more likely than not” that the asset is impaired. Adoption of this new guidance did not impact our financial statements.

On July 1, 2013, we adopted ASU 2011-11 enhancing disclosure requirements about the nature of an entity’s right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, amounts offset in accordance with the accounting standards followed, and the related net exposure. Adoption of this new guidance did not impact our financial statements.

Recent accounting guidance not yet adopted

In July 2013, the FASB issued ASU 2013-11 regarding disclosures in the financial statements for an unrecognized tax benefit when a net operating loss carry forward exists. The new guidance will become effective for us beginning July 1, 2014 and is not expected to impact our financial statements upon adoption.

Note 3 – Concentration of Credit Risk, Other Concentration Risks and Significant Customers

We are exposed to interest rate risks. Our investment income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in shorter duration fixed income securities. We have no outstanding debt nor do we utilize auction rate securities or derivative financial instruments in our investment portfolio.

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 57.2% of net revenues in the three months ended March 31, 2014, and 65.6% of net revenues in the three months ended March 31, 2013. Sales outside North America represented approximately 43.6% of net revenues in the nine months ended March 31, 2014, and 50.7% of net revenues in the nine months ended March 31, 2013.

One customer accounted for 13.2% of the Company's revenue for the three-month period ended March 31, 2014. The customer's accounts receivable balance, net of specific allowances, totaled approximately 21.4% of net accounts receivable as of March 31, 2014. Two customers' accounted for 17.2% and 11.6% of the Company's revenue for the three-month period ended March 31, 2013. The customers' accounts receivable balances, net of specific allowances, totaled approximately 18.8% and 7.4%, of net accounts receivable as of March 31, 2013.

Two customers accounted for 12.3% and 10.6% of the Company's revenue for the nine-month period ended March 31, 2014. The customers' accounts receivable balances, net of specific allowances, totaled approximately 4.8% and 21.4%, respectively, of net accounts receivable as of March 31, 2014. Two customers accounted for 9.4% and 10.2% of the Company's revenue for the nine-month period ended March 31, 2013. The customer's accounts receivable balance, net of specific allowances, totaled approximately 7.4% and 18.8% of net accounts receivable as of March 31, 2013.

Note 4 – Loss per Share

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Basic loss per share has been computed by dividing net loss by the weighted average number of common shares outstanding. Diluted loss per share has not been computed as the effect is antidilutive.

The following table sets forth the computation of basic and diluted net loss per share for the periods indicated:

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|------------|----------------------|------------|
| | March 31, 2014 | 2013 | March 31, 2014 | 2013 |
| In thousands (except per share amounts): | | | | |
| Net loss (a) | \$(2,169) | \$(3,301) | \$(4,947) | \$(6,920) |
| Weighted average outstanding shares of common stock (b) | 12,253 | 12,253 | 12,253 | 12,253 |
| Dilutive potential common shares from employee stock options | - | - | - | - |
| Common stock and common stock equivalents (c) | 12,253 | 12,253 | 12,253 | 12,253 |
| Loss per share: | | | | |
| Basic net loss per share (a)/(b) | \$(0.18) | \$(0.27) | \$(0.40) | \$(0.56) |
| Diluted net loss per share (a)/(c) | \$(0.18) | \$(0.27) | \$(0.40) | \$(0.56) |

QUALSTAR CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS- (Continued)

Note 5 – Fair Value Measurements

Fair value is the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is estimated by applying the following hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

Level 1 – Quoted prices in active markets for identical assets or liabilities.

Level 2 – Observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated observable market data for substantially the full term of the assets or liabilities.

Level 3 – Inputs that are generally unobservable and typically reflect management’s estimate of assumptions that market participants would use in pricing the asset or liability.

Note 6 – Cash, Cash Equivalents and Marketable Securities Recorded at Fair Value

All highly liquid investments with maturities of three months or less at the date of purchase are classified as cash equivalents. The Company’s marketable debt securities have been classified and accounted for as available-for-sale. Management determines the appropriate classification of its investments at the time of purchase and re-evaluates the available-for-sale designations as of each balance sheet date. The Company classifies its marketable debt securities as either short-term or long-term based on each instrument’s underlying contractual maturity date. Marketable debt securities with maturities of 12 months or less are classified as short-term and marketable debt securities with maturities greater than 12 months are classified as long-term.

The following tables summarize the Company's available-for-sale securities' adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash and cash equivalents or short-term or long-term marketable securities as of March 31, 2014 and June 30, 2013 (in thousands):

March 31, 2014

| | Adjusted Unrealized | | Unrealized Losses | Fair Value | Cash & | | |
|------------------------|---------------------|-------|-------------------|------------|----------|----------------------------------|---------------------------------|
| | Cost | Gains | | | Cash | Short-term Marketable Securities | Long-term Marketable Securities |
| Level 1: | | | | | | | |
| Cash | 1,144 | - | - | 1,144 | 1,144 | - | - |
| Money Market Funds | 3,679 | - | - | 3,679 | 3,679 | - | - |
| Subtotal | \$4,823 | \$ - | \$ - | \$4,823 | \$ 4,823 | \$ - | \$ - |
| Level 2: | | | | | | | |
| U.S. Agency Securities | 335 | 1 | - | 336 | - | 336 | - |
| Corporate securities | 1,998 | 2 | (1) | 1,999 | - | 1,800 | 199 |
| Municipal securities | 581 | 1 | - | 582 | - | 582 | - |
| Subtotal | \$2,914 | \$ 4 | \$ (1) | \$2,917 | \$ - | \$ 2,718 | \$ 199 |
| Total | \$7,737 | \$ 4 | \$ (1) | \$7,740 | \$ 4,823 | \$ 2,718 | \$ 199 |

June 30, 2013

| | Adjusted Unrealized | | Unrealized Losses | Fair Value | Cash & | | |
|----------------------------|---------------------|-------|-------------------|------------|----------|----------------------------------|---------------------------------|
| | Cost | Gains | | | Cash | Short-term Marketable Securities | Long-term Marketable Securities |
| Level 1: | | | | | | | |
| Cash | 1,257 | - | - | 1,257 | 1,257 | - | - |
| Money Market Funds | 709 | - | - | 709 | 709 | - | - |
| U.S. Treasury Securities | 503 | - | - | 503 | - | 503 | - |
| Subtotal | \$2,469 | \$ - | - | \$2,469 | \$ 1,966 | \$ 503 | \$ - |
| Level 2: | | | | | | | |
| U.S. Agency Securities | 544 | - | (1) | 543 | - | - | 543 |
| Corporate securities | 4,915 | 1 | (11) | 4,905 | - | 2,745 | 2,160 |
| Municipal securities | 5,728 | 15 | - | 5,743 | - | 2,900 | 2,843 |
| Asset backed securities | 127 | - | - | 127 | - | 127 | - |
| Mortgage backed securities | 30 | - | - | 30 | - | 30 | - |
| Subtotal | \$11,344 | \$ 16 | (12) | \$11,348 | - | \$ 5,802 | \$ 5,546 |
| Total | \$13,813 | \$ 16 | (12) | \$13,817 | \$ 1,966 | \$ 6,305 | \$ 5,546 |

QUALSTAR CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS- (Continued)

There were unrealized loss positions as of March 31, 2014. The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2014 and June 30, 2013 (in thousands):

| | Less Than 12 Months | | 12 Months or Greater | | Total | |
|----------------------|---------------------------------|--------------------|-------------------------|--------------------|---------------|--------------------|
| March 31, 2014 | Fair Value (In thousands) | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Corporate securities | 1,800 | (1) | 199 | - | 1,999 | (1) |
| Total | \$1,800 | \$ (1) | \$199 | \$ - | \$1,999 | \$ (1) |

| | Less Than 12 Months | | 12 Months or Greater | | Total | |
|------------------------|---------------------------------|--------------------|-------------------------|--------------------|---------------|--------------------|
| June 30, 2013 | Fair Value (In thousands) | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Agency securities | - | - | 543 | (1) | 543 | (1) |
| Corporate securities | 2,745 | (3) | 2,160 | (8) | 4,905 | (11) |
| Total | \$2,745 | \$ (3) | \$2,703 | \$ (9) | \$5,448 | \$ (12) |

Available-for-sale securities are recorded at market value. Unrealized holding gains and losses, net of the related income tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of shareholders' equity until realized. Dividend and interest income are recognized when earned. Realized gains and losses for securities classified as available-for-sale are included in earnings when the underlying securities are sold and are derived using the specific identification method for determining the cost of securities sold. There was no loss on the sale of marketable securities for the nine months ended March 31, 2014. Loss on the sale of marketable

securities for the nine months ended March 31, 2013 was \$47,000. The net unrealized loss on available-for-sale securities that has been included in the other comprehensive income of shareholders' equity during the nine months ended March 31, 2014 and 2013 was \$1,000 and \$14,000, respectively.

Note 7 - Inventories

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

| | March 31, | June 30, |
|-------------------------|----------------------|---------------------|
| | 2014 | 2013 |
| Raw materials | \$3,609 | \$1,027 |
| Finished goods | 2,695 | 1,684 |
| Subtotal | 6,304 | 2,711 |
| Less: Inventory reserve | (2,877) | (1,083) |
| Net inventory balance | \$3,427 | \$1,628 |

Certain items of inventory, specifically tape drives, have been reclassified from raw materials to finished goods at June 30, 2013, to be consistent with March 31, 2014.

Note 8 – Commitments and 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 generally is 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**NOTES TO CONDENSED FINANCIAL STATEMENTS- (Continued)**

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

| | Nine Months Ended | |
|---------------------------------|----------------------------------|-------------|
| | March 31, | |
| | 2014 | 2013 |
| Beginning balance | \$ 190 | \$ 205 |
| Cost of warranty claims | (44) | (51) |
| Accruals for product warranties | 20 | 40 |
| Ending balance | \$ 166 | \$ 194 |

Contract Termination

On December 20, 2013, Qualstar entered into a settlement agreement with their contract manufacturing provider, Benchmark Electronics Manufacturing Solutions, Inc., the successor to CTS Electronics Manufacturing Solutions, Inc., (“CTS”). The agreement terminated the relationship between CTS and Qualstar, and Qualstar agreed to purchase all inventory on hand at CTS that was being held on behalf of Qualstar. The net amount of the inventory purchased was \$1.9 million. The inventory was delivered to Qualstar in January 2014, at which time the purchase price and all related settlement surcharges were paid to CTS.

Note 9 – Comprehensive Loss

For the nine months ended March 31, 2014 and 2013, comprehensive loss amounted to approximately \$4,948,000 and \$6,906,000, respectively. The difference between net loss and comprehensive loss is \$(1,000) and \$14,000,

respectively, which relates to the changes in the unrealized gains that the Company recorded for its available-for-sale marketable securities.

Note 10 – Legal Proceedings

Overland Storage, Inc.

On June 28, 2012, Overland Storage, Inc. (“Overland”) filed a patent infringement lawsuit against Qualstar Corporation (and others) in the U.S. District Court in the Southern District of California, alleging that certain of our automated tape libraries infringe claims of U.S. Patent No. 6,328,766. The lawsuit is entitled: *Overland Storage, Inc. (Plaintiff/Counterclaim Defendant) v. Qualstar Corporation (Defendant/Counterclaim Plaintiff)*, and assigned Case No. 12-cv-1605-JLS-BLM. Overland is seeking injunctive relief as well as the recovery of unspecified monetary damages. We do not believe we infringe the Overland patent and we intend to defend ourselves vigorously. Due to the inherent uncertainty of litigation, we cannot identify probable or estimable damages related to the lawsuit at this time.

Lawrence D. Firestone and others

On August 12, 2013, Qualstar filed a complaint against former CEO Lawrence D. Firestone and others for breach of fiduciary duty, breach of duty of loyalty, breach of duty of care and the commission of corporate waste that is currently pending in the Superior Court of the State of California, County of Los Angeles. The lawsuit is entitled: *Qualstar Corporation v. Lawrence D. Firestone, Stanley Corker, Carl W. Gromada, Robert A. Meyer, Robert Rich, Daniel Molhoek, Allen Alley, Gerald Laber, Steven Wagner and Does 1 through 10, inclusive*, and assigned Case No. BC 514889. On April 17, 2014, Defendant Lawrence D. Firestone filed a cross-complaint against Qualstar for wrongful termination of employment in breach of contract, employer’s breach of the implied covenant of good faith and fair dealing, breach of contract, and conversion. Due to the inherent uncertainty of litigation, we cannot identify probable or estimable damages related to the cross-complaint at this time. Also on April 17, 2014, Qualstar voluntarily withdrew its claims against Defendant Gerald Laber, without prejudice. On April 18, 2014, the Court denied motions filed by the remaining Defendants that had been seeking the dismissal of all causes of action against all Defendants.

We also are subject to a variety of other claims and legal proceedings that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in the aggregate, will not have a material adverse impact on our 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 March 31, 2014, we had accrued aggregate current liabilities of \$337,000 in probable fees and costs related to our contingent legal matters.

QUALSTAR CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS- (Continued)

Note 11 – Income Taxes

We did not record a provision or benefit for income taxes for the nine months ended March 31, 2014 and 2013. The Company has recorded a full valuation allowance against its net deferred tax assets based on the Company's assessment regarding the realizability of these net deferred tax assets in future periods.

Note 12 – Segment Information

In its operation of the business, management reviews certain financial information, including segmented internal profit and loss statements prepared on a basis consistent with U.S. GAAP. Our two segments are Power Supplies and Storage. The two segments discussed in this analysis are presented in the way we internally managed and monitored performance for the nine months ended March 31, 2014 and 2013. Allocations for internal resources were made for the nine months ended March 31, 2014 and 2013. The power supplies segment tracks certain assets separately, and all others are recorded in the storage segment for internal reporting presentations. The types of products and services provided by each segment are summarized

below:

Power Supplies — We design, develop, and sell small, open frame, high efficiency switching power supplies. These power supplies are used to convert AC line voltage to DC voltages, or DC voltages to other DC voltages for use in a wide variety of electronic equipment such as telecommunications equipment, machine tools, routers, switches, wireless systems and gaming devices.

Storage — We design, develop and sell automated magnetic tape libraries used to store, retrieve and manage electronic data primarily in network computing environments. Tape libraries consist of cartridge tape drives, tape cartridges and robotics to move the cartridges from their storage locations to the tape drives under software control. Our tape

libraries provide data storage solutions for organizations requiring backup, recovery and archival storage of critical data.

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

| | Three Months Ended | | Nine Months Ended | |
|----------------|-------------------------------|-------------|------------------------------|-------------|
| | March 31, 2014 | 2013 | March 31, 2014 | 2013 |
| Revenue | | | | |
| Power Supplies | \$ 1,525 | \$ 1,969 | \$ 4,321 | \$ 4,742 |
| Storage: | | | | |
| Product | 457 | 793 | 2,301 | 3,547 |
| Service | 580 | 190 | 1,570 | 1,471 |
| Total storage | \$ 1,037 | \$ 983 | \$ 3,871 | \$ 5,018 |
| Total revenue | \$ 2,562 | \$ 2,952 | \$ 8,192 | \$ 9,760 |

| | Three Months Ended | | Nine Months Ended | |
|--------------------------|-------------------------------|-------------|------------------------------|-------------|
| | March 31, 2014 | 2013 | March 31, 2014 | 2013 |
| Loss before Taxes | | | | |
| Power Supplies | \$(392) | \$(262) | \$(779) | \$(828) |
| Storage | (1,777) | (3,039) | (4,168) | (6,092) |
| Total loss before taxes | \$(2,169) | \$(3,301) | \$(4,947) | \$(6,920) |

| | March 31, 2014 | June 30, 2013 |
|--------------------------------------|-------------------------------|------------------------------|
| Total Assets | | |
| Cash and marketable securities: | | |
| Cash and cash equivalents | \$ 4,823 | \$ 1,966 |
| Marketable securities | 2,917 | 11,851 |
| Total cash and marketable securities | \$ 7,740 | \$ 13,817 |
| Other assets: | | |
| Power Supplies | 2,529 | 2,893 |
| Storage | 3,543 | 3,497 |
| Total other assets | \$ 6,072 | \$ 6,390 |

QUALSTAR CORPORATION**NOTES TO CONDENSED FINANCIAL STATEMENTS- (Continued)****Note 13 – Restructuring Expenses****Restructuring Charges**

In fiscal 2013, the Company restructured its operations and overhead structure related to the storage division by reducing the size of its facilities and headcount, in accordance with a defined restructuring plan. Costs associated therewith were separately identified and disclosed. In October 2013, the Company determined that we would no longer require the leased space in Boulder, Colorado. The space has been vacated and the landlord is currently looking for another tenant. Until that time, we are obligated through the term of the lease, September 2014. In October 2013, the total amounts of the lease payments were added to the restructuring charges in the amount of \$26,000.

| | Beginning | | | Ending |
|--------------------------------|------------------|-----------------|-------------|----------------|
| | Balance | | | Balance |
| | June 30, | Expensed | Paid | March |
| | 2013 | | | 31, |
| | | | | 2014 |
| Lease abandonment obligation | \$ 1,040 | \$ 26 | \$(312) | \$ 754 |
| Total Restructuring Obligation | \$ 1,040 | \$ 26 | \$(312) | \$ 754 |

Note 14 – Shareholder Activism

As a result of the proxy contest initiated by BKF Capital Group, Inc., ("BKF"), at the Annual Shareholders' Meeting, held on June 28, 2013, the entire Board of Qualstar was replaced by the five nominees of BKF. On August 19, 2013, the Board approved the reimbursement of the expenses incurred by BKF in connection with its efforts to replace the

prior members of Qualstar's Board in an aggregate amount of \$395,000. Steven N. Bronson, the Company's Chairman and CEO, is also Chairman, CEO, and majority shareholder of BKF.

Note 15 – Subsequent Event

The Company entered into a license agreement, dated May 1, 2014 (the “License Agreement”) with BKF Capital Group, Inc. (“BKF”). Pursuant to the License Agreement, commencing on May 1, 2014, BKF shall have a license to occupy and use one furnished office located at Qualstar’s executive offices located at 3990-B Heritage Oak Court, Simi Valley, California 93063 (the “Premises”). Pursuant to the License Agreement, BKF shall pay to Qualstar a license fee equal to \$14,400.00 per year, or \$1,200.00 per month, for use of the Premises. BKF shall also have access to a telephone line and other services as described in the License Agreement. Steven N. Bronson, the Company’s Chairman and CEO, is also the Chairman, CEO and majority shareholder of BKF. A copy of the License Agreement is attached as Exhibit 10.9 to the Company's Current Report on Form 8-K filed on May 2, 2014.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Statements in this Quarterly Report on Form 10-Q concerning the future business, operating results and financial condition of Qualstar including estimates, projections, statements relating to our business plans, objectives and operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements inherently are subject to risks and uncertainties, some of which we cannot predict or quantify. Our actual results may differ materially 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 Part II, Item 1A of this report and in our Annual Report on Form 10-K for the fiscal year ended June 30, 2013 in "Item 1 Business," "Item 1A Risk Factors," and in "Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations." You generally can identify forward-looking statements by the use of forward-looking terminology such as "believes," "may," "expects," "intends," "estimates," "anticipates," "plans," "seeks," or "continues," or the negative thereof or variations of similar terminology. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements to reflect the occurrence of events or circumstances in the future.

OVERVIEW

Qualstar Corporation ("Qualstar") is organized into two strategic business units, power supplies and storage. Power supply products include ultra-small high efficiency open frame switching power supplies and provide power solutions to original equipment manufacturers to incorporate into products for telecommunications and networking, industrial, gaming, test equipment and other applications. Storage products include automated magnetic tape libraries used to store, retrieve and manage electronic data primarily in the media and entertainment and network computing environment and provide solutions for organizations requiring backup, recovery and archival storage of critical electronic information.

As a result of the annual shareholders meeting held on June 28, 2013, Qualstar began fiscal 2014 under new leadership, focused on returning the Company to profitability. The two key elements of this strategy are cost reduction and sales growth.

In the first nine months of fiscal 2014, aggressive cost reduction actions were taken by the Company, including reduction of employees by 35%, elimination of most consultants, and the consolidation of operations in Simi Valley by closing the Denver, Colorado and Boulder, Colorado offices. We expect that these cost reduction efforts will continue for the foreseeable future.

In April, 2014 we hired Daniel Jan, as Executive Vice President, to oversee operations and business development. Moreover, to expand our sales efforts, we have appointed two Vice Presidents of International Sales, one focused on Europe and the other on Asia. Approximately 50% of our revenues in fiscal 2013 were from international markets and we believe international markets provide significant opportunities for growth in fiscal 2014.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

We describe our significant accounting policies in Note 1, “Summary of Significant Accounting Policies” of the accompanying Notes to Condensed Financial Statements.

RESULTS OF OPERATIONS

(Unaudited) (In thousands)

| | Three Months Ended | | Nine Months Ended | |
|----------------------------|-----------------------|---------|----------------------|---------|
| | March 31, | | March 31, | |
| | 2014 | 2013 | 2014 | 2013 |
| Power supply revenues | \$1,525 | \$1,969 | \$4,321 | \$4,742 |
| Storage revenues | 1,037 | 983 | 3,871 | 5,018 |
| Net revenues | 2,562 | 2,952 | 8,192 | 9,760 |
| Cost of goods sold | 2,761 | 2,080 | 6,422 | 6,675 |
| Gross profit | \$(199) | \$872 | \$1,770 | \$3,085 |
| Operating expenses: | | | | |
| Engineering | 501 | 854 | 1,979 | 2,262 |
| Sales and marketing | 484 | 846 | 1,728 | 2,181 |
| General and administrative | 992 | 1,576 | 3,009 | 3,235 |
| Restructuring expense | - | 913 | 26 | 2,306 |
| Total operating expenses | \$1,977 | \$4,189 | \$6,742 | \$9,984 |
| Loss from operations | (2,176) | (3,317) | (4,972) | (6,899) |
| Other income (expense) | 7 | 16 | 25 | (21) |
| Net loss | (2,169) | (3,301) | (4,947) | (6,920) |

The following table reflects, as a percentage of net revenues, statements of operations data for the periods indicated:

| | Three Months Ended | | Nine Months Ended | |
|----------------------------|-------------------------------|-------------|------------------------------|-------------|
| | March 31, | | March 31, | |
| | 2014 | 2013 | 2014 | 2013 |
| Power supply revenues | 59.5 % | 66.7 % | 52.7 % | 48.6 % |
| Storage revenues | 40.5 | 33.3 | 47.3 | 51.4 |
| Net revenues | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of goods sold | 107.8 | 70.5 | 78.4 | 68.4 |
| Gross profit | (7.8) | 29.5 | 21.6 | 31.6 |
| Operating expenses: | | | | |
| Engineering | 19.6 | 28.9 | 24.2 | 23.2 |
| Sales and marketing | 18.9 | 28.7 | 21.1 | 22.3 |
| General and administrative | 38.7 | 53.4 | 36.7 | 33.1 |
| Restructuring expense | - | 30.9 | 0.3 | 23.6 |
| Total operating expenses | 77.2 | 141.9 | 82.3 | 102.2 |
| Loss from operations | (85.0) | (112.4) | (60.7) | (70.6) |
| Other income (expense) | 0.3 | 0.5 | 0.3 | (0.2) |
| Net loss | (84.7)% | (111.9)% | (60.4)% | (70.8)% |

We have two operating segments for financial reporting purposes: power supplies and storage, as discussed in Note 12 of the accompanying Notes to Condensed Financial Statements in Item 1 of this report. The following table summarizes our revenue by operating segment in thousands of dollars:

| | Three Months Ended | | Nine Months Ended | |
|-----------------------|-------------------------------|-------------|------------------------------|-------------|
| | March 31, | | March 31, | |
| | 2014 | 2013 | 2014 | 2013 |
| Power supply revenues | \$1,525 | \$1,969 | \$4,321 | \$4,742 |
| Storage revenues | 1,037 | 983 | 3,871 | 5,018 |
| | \$2,562 | \$2,952 | \$8,192 | \$9,760 |

| | Three Months Ended | Nine Months Ended |
|--|-------------------------------|------------------------------|
|--|-------------------------------|------------------------------|

| | March 31, | | March 31, | |
|-----------------------|------------------|-------------|------------------|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Power supply revenues | 59.5 % | 66.7 % | 52.7 % | 48.6 % |
| Storage revenues | 40.5 | 33.3 | 47.3 | 51.4 |
| | 100.0% | 100.0% | 100.0% | 100.0% |

Three Months Ended March 31, 2014 Compared to Three Months Ended March 31, 2013

Net Revenues

Net revenues decreased to \$2.6 million for the three months ended March 31, 2014 from \$3.0 million for the three months ended March 31, 2013, a decrease of \$0.4 million, or 13.2%.

Segment Revenue

Power Supplies – Net revenues from power supplies were \$1.5 million for the three months ended March 31, 2014 compared with \$2.0 million for the three months ended March 31, 2013, a decrease of \$0.4 million, or 22.5%.

Storage – Net storage revenues remained consistent at \$1.0 million for the three months ended March 31, 2014 and 2013.

Gross Profit - Gross profit decreased to \$(0.2) million for the three months ended March 31, 2014 from \$0.9 million for the three months ended March 31, 2013. This decrease of \$1.1 million, or 122.8%, is primarily attributed to the \$1.3 million reserve for excess and obsolete inventory, taken as a result of the termination of the contract manufacturer, CTS Electronics Manufacturing Solutions, Inc.

Engineering: Engineering expenses decreased by \$353,000, or 41.3%, to \$501,000 for the three months ended March 31, 2014 from \$854,000 for the three months ended March 31, 2013. This decrease is primarily attributed to a reduction in salaries as we reduced headcount, consultant expenses and closed the Colorado facility.

Sales and Marketing: Sales and marketing expenses decreased by \$362,000 or 42.8%, to \$484,000 for the three months ended March 31, 2014 from \$846,000 for the three months ended March 31, 2013. The decrease is primarily attributed to a reduction in salaries and commissions as we reduced headcount and a reduction in advertising and tradeshow expenses.

General and Administrative. General and administrative expenses decreased by \$584,000 or 37.1%, to \$992,000 for the three months ended March 31, 2014 from \$1.6 million for the three months ended March 31, 2013. The decrease is primarily attributed to a reduction in salaries as we reduced headcount and a decrease in legal expenses.

Restructuring Expenses. Restructuring expenses decreased by \$913,000 in the three months ended March 31, 2014 to \$0. The Company underwent a major restructuring plan in fiscal year 2013 and expensed severance and facilities costs in the three months ended March 31, 2013.

Other Income. Other income decreased to \$7,000 for the three months ended March 31, 2014 from \$16,000 for the three months ended March 31, 2013 due to a reduction in investment income and losses on fixed asset disposals.

Provision for Income Taxes. We did not record a provision or benefit for income taxes for the three months ended March 31, 2014 or 2013.

Nine Months Ended March 31, 2014 Compared to Nine Months Ended March 31, 2013

Net Revenues

Net revenues decreased to \$8.2 million for the nine months ended March 31, 2014 compared with \$9.8 million for the nine months ended March 31, 2013, a decrease of \$1.6 million, or 16.1%.

Segment Revenue

Power Supplies – Net revenues from power supplies decreased to \$4.3 million for the nine months ended March 31, 2014 from \$4.7 million for the nine months ended March 31, 2013, a decrease of \$0.4 million, or 8.5%.

Storage – Net storage revenues decreased to \$3.9 million for the nine months ended March 31, 2014 from \$5.0 million for the nine months ended March 31, 2013, a decrease of \$1.1 million, or 22%. The decrease in revenues is primarily attributed to decreases in revenues from sales of our XLS tape libraries, legacy TLS, partially offset by an increase in revenues from sales of our RLS tape libraries and miscellaneous.

Gross Profit. Gross profit decreased to \$1.8 million for the nine months ended March 31, 2014 from \$3.1 million for the nine months ended March 31, 2013. This decrease of \$1.3 million, or 42.6%, was primarily attributed to an increase in inventory reserves of \$1.4 million. Gross margins decreased to 21.6% of revenues for the nine months ended March 31, 2014 from 31.6% for the nine months ended March 31, 2013.

Engineering. Engineering expenses decreased by \$283,000, or 12.5%, to \$2.0 million for the nine months ended March 31, 2014 from \$2.3 million for the nine months ended March 31, 2013. This decrease is attributed to the closure of the Colorado facility and reduction of headcount.

Sales and Marketing. Sales and marketing expenses decreased by \$453,000, or 20.8%, to \$1.8 million for the nine months ended March 31, 2014 from \$2.2 million for the nine months ended March 31, 2013. The decrease was attributed to a reduction in advertising, printing and consulting expenses, partially offset by an increase in severance costs related to a reduction in headcount.

General and Administrative. General and administrative expenses decreased by \$226,000, or 7.0%, to \$3.0 million for the nine months ended March 31, 2014 from \$3.2 million for the nine months ended March 31, 2013. The decrease was primarily attributed to a reduction in salaries as we reduced headcount.

Restructuring Expense. Restructuring expenses decreased by \$2.3 million in the nine months ended March 31, 2014 to \$26,000. The Company underwent a major restructuring plan in fiscal year 2013 and expensed items such as, severance and facilities costs in the nine months ended March 31, 2013.

Other Income. Other income increased 219% to \$25,000 for the nine months ended March 31, 2014 from other expenses of (\$21,000) for the nine months ended March 31, 2013, due to the absence of litigation settlements in fiscal year 2014.

Provision for Income Taxes. We did not record a provision or benefit for income taxes for the nine months ended March 31, 2014 or 2013.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was \$5.9 million in the nine months ended March 31, 2014, primarily attributed to the \$4.9 million net loss for the period, a decrease of \$1.2 million in accounts payable, a \$1.8 million increase in net inventory, partially offset by a decrease of \$2.1 million in total net accounts receivable. Net cash used in operating activities was \$3.7 million in the nine months ended March 31, 2013, primarily attributed to the net loss for the period, an increase in accounts receivable, prepaid and other assets, and a decrease in accounts payable, partially offset by a decrease in inventory and an increase in restructuring liability and deferred revenue.

Cash provided by investing activities was \$8.8 million in the nine months ended March 31, 2014, is primarily attributed to the sale of marketable securities. Cash used in investing activities was \$2.8 million in the nine months ended March 31, 2013, primarily attributed to the purchase of marketable securities and equipment, partially offset by proceeds from the sale marketable securities.

Cash was not used in financing activities during the nine months ended March 31, 2014 or 2013.

As of March 31, 2014, we had \$4.8 million in cash and cash equivalents and \$2.9 million in marketable securities. The increase in cash from June 30, 2013 consisted of approximately \$2.9 million provided by sale of marketable securities.

We believe that our existing cash and cash equivalents and cash flows from our operating activities, plus funds available from the sale of our marketable securities, will be sufficient to fund our working capital and capital expenditure needs for the next 12 months. We may utilize cash to invest in or acquire businesses, products or technologies that we believe are strategic. We periodically evaluate other companies and technologies for possible investment or acquisition by us. In addition, we have made and may in the future make investments in companies with whom we have identified potential synergies. However, we have no present commitments or agreements with respect to any material investment in or acquisition of other businesses or technologies.

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

We develop products in the United States and sell them worldwide. We manufacture products in the United States and Asia. As a result, our financial results could be affected by factors such as 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

U.S. dollar could make our products less competitive in foreign markets. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We have no outstanding debt nor do we utilize derivative financial instruments. Therefore, no quantitative tabular disclosures are required.

ITEM 4. CONTROLS AND PROCEDURES

We maintain "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our principal executive officer to allow timely decisions regarding required disclosure.

Evaluation of disclosure and controls and procedures.

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's Disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on the evaluation, the Company's Chief Executive Officer and Chief Financial Officer has concluded that the Company's disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that the Company's disclosure controls and procedures are operating in an effective manner to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in internal controls over financial reporting.

There have been no changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the Company's most recent quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based

in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there is only reasonable assurance that the Company's controls will succeed in achieving their stated goals under all potential future conditions.

PART II — OTHER INFORMATION

ITEM 1. Legal Proceedings

On June 28, 2012, Overland Storage, Inc. (“Overland”) filed a patent infringement lawsuit against Qualstar Corporation (and others) in the U.S. District Court in the Southern District of California, alleging that certain of our automated tape libraries infringe claims of U.S. Patent No. 6,328,766. The lawsuit is entitled: *Overland storage, Inc. (Plaintiff/Counterclaim Defendant) v. Qualstar Corporation (Defendant/Counterclaim Plaintiff)*, and assigned Case No. 12-cv-1605-JLS-BLM. Overland is seeking injunctive relief as well as the recovery of unspecified monetary damages. We do not believe we infringe the Overland patent and we have filed a counterclaim. Due to the inherent uncertainty of litigation, we cannot identify probable or estimable damages related to the lawsuit at this time.

On September 18, 2013, Qualstar filed an amended complaint against former CEO Lawrence D. Firestone and others for breach of fiduciary duty, breach of duty of loyalty, breach of duty of care, and the commission of corporate waste that is currently pending in the Superior Court of the State of California, County of Los Angeles. The lawsuit is entitled: *Qualstar Corporation v. Lawrence D. Firestone, Stanley Corker, Carl W. Gromada, Robert A. Meyer, Robert Rich, Daniel Molhoek, Allen Alley, Gerald Laber, Steven Wagner and Does 1 through 10, inclusive*, and assigned Case No. BC 514889. Qualstar is seeking to enjoin the payment of Lawrence D. Firestone’s severance package and the recovery of monetary damages to be proven at trial. On April 17, 2014, Defendant Lawrence D. Firestone filed a cross-complaint against Qualstar for wrongful termination of employment in breach of contract, employer’s breach of the implied covenant of good faith and fair dealing, breach of contract, and conversion. Due to the inherent uncertainty of litigation, we cannot identify probable or estimable damages related to the cross-complaint at this time. Also on April 17, 2014, Qualstar voluntarily withdrew its claims against Defendant Gerald Laber, without prejudice. On April 18, 2014, the Court denied motions filed by the remaining Defendants that had been seeking the dismissal of all causes of action against all Defendants.

We also are subject to a variety of other claims and legal proceedings that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in the aggregate, will not have a material adverse impact on our 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 March 31, 2014, we had accrued aggregate current liabilities of \$337,000 in probable fees and costs related to our contingent legal matters.

ITEM 1A. Risk Factors

There have been no significant changes to the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2013.

ITEM 5. Other Information

On December 20, 2012, Qualstar Corporation entered into a contract manufacturing agreement with CTS Electronics Manufacturing Solutions, Inc. (CTS) whereby CTS was going to manufacture Qualstar's RLS and XLS tape libraries. At the commencement of the contract, Qualstar's then management provided CTS with a very aggressive forecast of Qualstar requirements for RLS tape libraries. However, actual sales of Qualstar's RLS tape libraries did not match the aggressive forecast of the prior management team. Accordingly, CTS purchased more parts than were required to satisfy Qualstar's sales, in addition to the excessive set up fees that CTS charged to Qualstar in June of 2013. After taking control of Qualstar in July 2013, the new management team scaled back its forecast for the RLS tape libraries, in order to fairly project actual marketplace demand. The lower forecast provided for a level of business that was not economically beneficial to CTS and strains in the relationship between Qualstar and CTS began to develop. Shortly thereafter the new management team began to look for alternatives to the contract manufacturing relationship with CTS, such as bringing the manufacturing of the RLS and XLS tape libraries in house at Qualstar. On December 20, 2013, Qualstar and Benchmark Electronics Manufacturing Solutions, Inc. (the successor to CTS) entered into a settlement agreement ("Settlement Agreement"), whereby the contract manufacturing relationship was terminated and the parties agreed that Qualstar would purchase from CTS all Qualstar inventory on hand. Qualstar completed the purchase of CTS's parts inventory in January 2014 for a total of \$1.9 million. Qualstar is currently manufacturing its RLS tape libraries in house for the foreseeable future. As a result of the Settlement Agreement Qualstar now has excess inventory. A detailed review was completed of the tape library inventory and a reserve of \$1.6 million was recorded for excess and obsolete inventory. We also incurred surcharges on various inventory parts that CTS purchased on Qualstar's behalf due to the terms of the contract previous management entered into with CTS.

We believe that bringing the tape library manufacturing back to Qualstar will benefit our customers by providing better product quality and service. It will also give us more control over our inventory levels, and improve our flexibility in inventory planning. Finally, it relieves Qualstar of all remaining obligations from a contract manufacturing relationship that was not beneficial for Qualstar.

Subsequent Event

The Company entered into a license agreement, dated May 1, 2014 (the "License Agreement") with BKF Capital Group, Inc. ("BKF"). Pursuant to the License Agreement, commencing on May 1, 2014, BKF shall have a license to occupy and use one furnished office located at Qualstar's executive offices located at 3990-B Heritage Oak Court, Simi Valley, California 93063 (the "Premises"). Pursuant to the License Agreement, BKF shall pay to Qualstar a license fee equal to \$14,400.00 per year, or \$1,200.00 per month, for use of the Premises. BKF shall also have access to a

telephone line and other services as described in the License Agreement. Steven N. Bronson, the Company's Chairman and CEO, is also the Chairman, CEO and majority shareholder of BKF. A copy of the License Agreement is attached as Exhibit 10.9 to the Company's Current Report on Form 8-K filed on May 2, 2014.

ITEM 6. EXHIBITS

Exhibit

| No. | Exhibit Index |
|------------|---|
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

QUALSTAR CORPORATION

Dated: May 13, 2014 By: /s/ STEVEN N. BRONSON
Steven. N. Bronson
Chief Executive Officer and President
(Principal Executive Officer)

