

QUALSTAR CORP  
Form 10-Q  
November 12, 2009

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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 Ended September 30, 2009

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  
(State of incorporation)

95-3927330  
(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

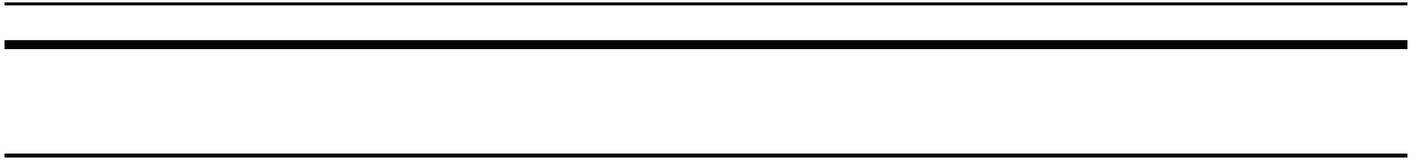
Indicate by check mark whether the registrant has submitted electronically and posted on its website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that 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 "accelerated filer," "large 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 September 30, 2009 is 12,253,117.



QUALSTAR CORPORATION  
 FORM 10-Q  
 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2009  
 INDEX

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

	<u>Condensed Consolidated Balance Sheets — September 30, 2009 and June 30, 2009</u>	
·	<u>Condensed Consolidated Statements of Operations — Three months ended September 30, 2009 and 2008</u>	2
·	<u>Condensed Consolidated Statements of Cash Flows — Three months ended September 30, 2009 and 2008</u>	3
·	<u>Condensed Consolidated Statement of Changes in Shareholders' Equity — Three months ended September 30, 2009</u>	4
·	<u>Notes to Condensed Consolidated Financial Statements</u>	5

Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
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Item 3.	<u>Qualitative and Quantitative Disclosures About Market Risk</u>	17
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Item 4T.	<u>Controls and Procedures</u>	17
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PART II — OTHER INFORMATION

Item 1A.	<u>Risk Factors</u>	18
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Item 6.	<u>Exhibits</u>	18
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	<u>Signatures</u>	19
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Index

## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

QUALSTAR CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands)

	September 30, 2009 (Unaudited)	June 30, 2009 (Audited)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$2,384	\$3,749
Marketable securities, short-term	14,142	16,856
Receivables, net of allowances of \$60 at September 30, 2009, and \$85 at June 30, 2009	2,098	2,305
Inventories, net	5,622	5,822
Prepaid expenses and other current assets	410	397
Total current assets	24,656	29,129
Property and equipment, net	317	361
Marketable securities, long-term	10,010	7,056
Other assets	46	46
Total assets	\$35,029	\$36,592
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$941	\$649
Accrued payroll and related liabilities	395	505
Other accrued liabilities	861	894
Total current liabilities	2,197	2,048
Other long term liabilities	34	34
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 September 30, 2009 and June 30, 2009	18,805	18,798
Accumulated other comprehensive income	135	168
Retained earnings	13,858	15,544
Total shareholders' equity	32,798	34,510
Total liabilities and shareholders' equity	\$35,029	\$36,592

See notes to condensed consolidated financial statements.

Index

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

	Three Months Ended September 30,	
	2009	2008
Net Revenues	\$3,679	\$5,402
Cost of goods sold	2,716	3,519
Gross profit	963	1,883
Operating expenses:		
Research and development	802	743
Sales and marketing	544	695
General and administrative	671	766
Total operating expenses	2,017	2,204
Loss from operations	(1,054 )	(321 )
Investment Income	103	280
Loss before income taxes	(951 )	(41 )
Benefit for income taxes	-	(2 )
Net loss	\$(951 )	\$(39 )
Loss per common share:		
Basic and Diluted	\$ (0.08 )	\$(0.00 )
Weighted average common shares outstanding:		
Basic and Diluted	12,253	12,253
Cash dividends declared per common share	\$0.06	\$0.00

See notes to condensed consolidated financial statements.

Index

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

	Three Months Ended September 30,	
	2009	2008
<b>OPERATING ACTIVITIES:</b>		
Net loss	\$(951 )	\$(39 )
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	46	56
Provision for (recovery of) bad debts and returns, net	(15 )	2
Provision for (recovery of) inventory reserve	123	(78 )
Stock based compensation	7	24
(Gain) loss on sale of securities	-	4
Changes in operating assets and liabilities:		
Accounts receivable	222	(283 )
Inventories	77	(22 )
Prepaid expenses and other assets	(13 )	(84 )
Accounts payable	292	48
Accrued payroll and related liabilities	(111 )	(99 )
Other accrued liabilities	(32 )	(36 )
Net cash used in operating activities	(355 )	(507 )
<b>INVESTING ACTIVITIES:</b>		
Purchases of equipment	(2 )	(14 )
Purchases of marketable securities	(6,279 )	(7,846 )
Proceeds from the sale of marketable securities	6,006	10,884
Net cash (used in) provided by investing activities	(275 )	3,024
<b>FINANCING ACTIVITIES:</b>		
Cash dividends on common shares	(735 )	(735 )
Net cash used in financing activities	(735 )	(735 )
<b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(1,365 )</b>	<b>1,782</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>3,749</b>	<b>6,744</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$2,384</b>	<b>\$8,526</b>
<b>SUPPLEMENTAL CASH FLOW DISCLOSURES:</b>		
Income taxes paid	\$10	\$5

See notes to condensed consolidated financial statements.

Index

QUALSTAR CORPORATION  
 CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
 THREE MONTHS ENDED SEPTEMBER 30, 2009  
 (Unaudited) (In thousands)

	Common Stock		Accumulated Other Comprehensive	Retained	Total
	Shares	Amount	Income	Earnings	
Balance at June 30, 2009	12,253	\$ 18,798	\$ 168	\$ 15,544	\$ 34,510
Share-based compensation	—	7	—	—	7
Cash dividend on common shares	—	—	—	(735 )	(735 )
Comprehensive loss:					
Net loss	—	—	—	(951 )	(951 )
Change in unrealized losses on investments	—	—	(33 )	—	(33 )
Comprehensive Loss	—	—	—	—	(984 )
Balance at September 30, 2009	12,253	\$ 18,805	\$ 135	\$ 13,858	\$ 32,798

See notes to condensed consolidated financial statements

Index

QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 – Basis of Presentation and Consolidation

Basis of Presentation

In the opinion of management, the accompanying consolidated condensed financial statements, including balance sheets and related interim statements of operations, cash flows, and stockholders' 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, 2009, filed with the Securities and Exchange Commission ("SEC") on September 25, 2009.

Basis of Consolidation

The consolidated financial statements include the accounts and operations of Qualstar and its wholly owned subsidiary. All significant intercompany accounts have been eliminated.

The Company's wholly owned subsidiary, Qualstar Sales and Service Corporation, was liquidated and dissolved pursuant to a plan of dissolution which was adopted by the board of directors and approved by the sole shareholder of Qualstar Sales and Service Corporation on June 30, 2009. Pursuant to the plan of dissolution, all assets of Qualstar Sales and Service Corporation were distributed to Qualstar Corporation, and all liabilities of Qualstar Sales and Service Corporation were assumed by Qualstar Corporation, effective June 30, 2009.

Note 2 – Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

On September 15, 2009, we adopted the authoritative guidance that establishes only two levels of U.S. generally accepted accounting principles ("GAAP"): authoritative and nonauthoritative. The FASB Accounting Standards Codification (the "Codification") will become the source of authoritative U.S. accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP, except for rules and interpretive releases of the Securities and Exchange Commission ("SEC"), which continue to be sources of authoritative GAAP for SEC registrants. All nongrandfathered, non-SEC accounting literature not included in the Codification will become nonauthoritative. Adoption of the new guidance did not have a material impact on our

financial statements.

On July 1, 2009 we adopted the authoritative guidance on fair value measurement, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Adoption of the new guidance did not have a material impact on our financial statements.

5

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Index

QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS- (Continued)

On July 1, 2009 we adopted the authoritative guidance issued by the Financial Accounting Standards Board (“FASB”) on business combinations. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. Adoption of the new guidance did not have a material impact on our financial statements.

On July 1, 2009 we adopted the authoritative guidance issued by the FASB that changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent’s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in net income. Adoption of the new guidance did not have a material impact on our financial statements.

Recent Accounting Pronouncements Not Yet Adopted

In June 2009, the FASB issued authoritative guidance which is effective for us beginning July 1, 2010. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. Adoption of the new guidance will not have a material impact on our financial statements.

In October 2009, the FASB issued authoritative guidance on revenue recognition that will become effective for us beginning July 1, 2010, with earlier adoption permitted. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued authoritative guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe adoption of this new guidance will not have a material impact on our financial statements.

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

We are exposed to interest rate risks. 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 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 of North America represented approximately 24.1% of net revenues in the three months ended September 30, 2009, and 26.8% of net revenues in the three months ended September 30, 2008.

Two customers accounted for 11.8% and 10.8%, respectively, or 22.6% in the aggregate, of the Company's consolidated revenue for the three-month period ended September 30, 2009. The customers' accounts receivable balances, net of specific allowances, totaled approximately 5.7% and 15.0%, respectively, or 20.7% in the aggregate, of net accounts receivable as of September 30, 2009. Two customers accounted for 11.1% and 10.6%, respectively, or 21.7% in the aggregate, of the company's consolidated revenue for the three-month period ended September 30, 2008. The customers' accounts receivable balances, net of specific allowances, totaled approximately 3.9% and 16.1%, respectively, or 20.0% in the aggregate, of net accounts receivable as of September 30, 2008.

Index

## QUALSTAR CORPORATION

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

Sales and costs of goods sold related to tape library products only available from one supplier totaled approximately 13.9% and 15.6% for the three months ended September 30, 2009 and 15.1% and 18.0% for the three months ended September 30, 2008, respectively, of total sales and cost of goods sold.

## Note 4 – Loss Per Share

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 been computed by dividing net loss 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 loss per share for the periods indicated:

In thousands (except per share amounts):	Three Months Ended September 30,	
	2009	2008
Net loss (a)	\$ (951 )	\$ (39 )
Weighted average outstanding shares of common stock (b)	12,253	12,253
Dilutive potential common shares from employee stock options	—	—
Common stock and common stock equivalents (c)	12,253	12,253
Loss per share:		
Basic net loss per share (a)/(b)	\$ (0.08 )	\$ (0.00 )
Diluted net loss per share (a)/(c)	\$ (0.08 )	\$ (0.00 )

Stock options are excluded for the three-month periods ended September 30, 2009 and 2008, respectively, from the computation of diluted loss per share, as the effect would have been anti-dilutive.

## Note 5 – Marketable Securities

Marketable securities consist primarily of commercial paper, U.S. government and agency securities, mortgage-backed securities and corporate bonds. These securities are classified in one of three categories: trading, available-for-sale, or held-to-maturity. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity securities are those securities which Qualstar has the ability and intent to hold until maturity. All other securities not included in trading or held-to-maturity are classified as available-for-sale. All of Qualstar's marketable securities were classified as available-for-sale at September 30, 2009 and June 30, 2009.

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 gain or loss on the sale of marketable securities for the three months ended September 30, 2009. Gain on the sale of securities for the three months ended September 30, 2008 was \$4,000. The change in net unrealized holding gain (loss) on available-for-sale securities that has been included in the other comprehensive income of shareholder's equity during the three months ended September 30, 2009 and 2008 was \$33,000 and \$(220,000), respectively.



Index

## QUALSTAR CORPORATION

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

## Note 6 – Financial Instruments

We account for certain assets and liabilities at fair value. Fair value is defined as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability. The fair value should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk including our own credit risk.

The hierarchy below prioritizes the valuation inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

- Level 1 – inputs are based upon unadjusted quoted prices for identical instruments traded in active markets.
- Level 2 – inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 – inputs are generally unobservable and typically reflect management’s estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques that include option pricing models, discounted cash flow models, and similar techniques.

In general, and where applicable, we use quoted prices in active markets for identical assets to determine fair value. This pricing methodology applies to our Level 1 investments such as U.S. treasuries and agency securities and exchange-traded mutual funds. If quoted prices in active markets for identical assets are not available to determine fair value, then we use quoted prices for similar assets or inputs other than the quoted prices that are observable either directly or indirectly. These investments are included in Level 2 and consist primarily of corporate bonds, mortgage-backed securities, and certain agency securities. While we own certain mortgage-backed fixed income securities, our portfolio as of September 30, 2009 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. Our mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association and Federal Home Loan Mortgage Corporation.

## Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents our assets and liabilities measured at fair value on a recurring basis at September 30, 2009 (in thousands):

Assets	Level 1	Level 2	Net Balance
Cash	\$ 903	–	\$ 903
Money Market Mutual fund	1,481	–	1,481
U.S. government and agency securities	11,842	10,044	21,886

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Mortgage-backed securities	–	1,901	1,901
Corporate bonds	–	365	365
Total	\$ 14,226	\$ 12,310	\$ 26,536

8

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Index

## QUALSTAR CORPORATION

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

## 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):

	September 30, 2009	June 30, 2009
Raw materials	\$ 5,020	\$ 5,389
Finished goods	1,547	1,248
Subtotal	6,567	6,637
Less: Inventory reserve	(945 )	(815 )
	\$ 5,622	\$ 5,822

## Note 8 – Warranty Obligations

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 generally include parts and labor over a three-year period. We regularly re-evaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

Activity in the liability for product warranty for the periods presented were as follows (in thousands):

	Three Months Ended September 30,	
	2009	2008
Beginning balance	\$ 167	\$ 181
Cost of warranty claims	(16 )	(17 )
Accruals for product warranties	11	17
Ending balance	\$ 162	\$ 181

## Note 9 – Comprehensive Loss

For the three months ended September 30, 2009 and 2008, comprehensive loss amounted to approximately \$984,000 and \$259,000, respectively. The difference between net loss and comprehensive loss relates to the changes in the unrealized losses or gains the Company recorded for its available-for-sale marketable securities.

## Note 10 – Legal Proceedings

We are from time to time involved in various lawsuits and legal proceedings that arise in the ordinary course of business. At this time, we are not aware of any pending or threatened litigation against us that we expect will have a material adverse effect on our business, financial condition, liquidity or operating results. Legal claims are inherently uncertain, however, and it is possible that the Company's business, financial condition, liquidity and/or operating results could be adversely affected in the future by legal proceedings.

Note 11 – Income Taxes

We did not record a provision or benefit for income taxes for the three months ended September 30, 2009. We recorded a benefit for income taxes of \$2,000 for the three months ended September 30, 2008 relating to state income taxes paid during the quarter and interest expense accrued as part of our liability.

9

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Index

## QUALSTAR CORPORATION

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

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 Tape Libraries and Power Supplies. The two segments discussed in this analysis are presented in the way we internally managed and monitored performance for the three months ended September 30, 2009 and 2008. Allocations for internal resources were made for the three months ended September 30, 2009 and 2008. Certain assets are tracked separately by the power supplies segment, and all others are recorded in the tape library segment for internal reporting presentations. Cash was not segregated between the two segments, but retained by the library segment through the third quarter of fiscal 2009. Cash was segregated between the two segments commencing in the fourth quarter of fiscal 2009.

The types of products and services provided by each segment are summarized below:

**Tape Libraries** — We design, develop, manufacture 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.

**Power Supplies** — We design, manufacture, 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.

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

	Three Months Ended September 30,	
	2009	2008
Revenue		
Tape Libraries:		
Product	\$1,756	\$3,077
Service	732	712
Total Tape Libraries	2,488	3,789
Power Supplies	1,191	1,613
Consolidated Revenue	\$3,679	\$5,402

Index

## QUALSTAR CORPORATION

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

	Three Months Ended September 30,	
	2009	2008
Income (Loss) before Taxes		
Tape Libraries	\$(891 )	\$(166 )
Power Supplies	(60 )	125
Consolidated Loss before Taxes	\$(951 )	\$(41 )
	September	June 30,
	30,	2009
	2009	2009
Total Assets		
Tape Libraries	\$35,720	\$37,172
Power Supplies	(691 )	(580 )
Consolidated Assets	\$35,029	\$36,592

## Note 13 – Subsequent Event

The Company has performed an evaluation of subsequent events through November 12, 2009, the date the Company issued these financial statements. On November 4, 2009, the Company announced that its Board of Directors declared a cash dividend of \$0.06 per share on its common stock. The cash dividend will be paid on December 10, 2009 to shareholders of record at the close of business on December 1, 2009. The dividend payment will be approximately \$735,000.

Index

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 our Annual Report on Form 10-K for the fiscal year ended June 30, 2009 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 thereon or 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

We design, develop, manufacture and sell automated magnetic tape libraries used to store, retrieve and manage electronic data primarily in network computing environments. We currently offer tape libraries for two tape drive technologies, LTO (Linear Tape-Open tape format) and AIT (Advanced Intelligent Tape).

We have developed a network of value added resellers who specialize in delivering complete storage solutions to end users. End users of our products range from small businesses requiring simple automated backup solutions to large organizations needing complex storage management solutions. We also sell our products to original equipment manufacturers that incorporate our products into theirs, which they sell as part of a system or solution. We assist our customers with marketing and technical support.

We also design, develop and sell high-efficiency switching power supplies used in telecommunications equipment, servers, routers, switches, RAIDs, and similar applications. Our power supplies are sold under the N2Power brand name through independent sales representatives and distributors. The primary customers are original equipment manufacturers and contract manufacturers. We also utilize these power supplies in some of our tape libraries.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to customer promotional offers, sales returns, bad debts, inventories, warranty costs, investments, share based compensation, and income taxes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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



## Index

### Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, shipment has occurred or services have been rendered, the fee is fixed or determinable and collectibility is reasonably assured (less estimated returns, for which provision is made at the time of sale). For product sales, title and risk of loss transfer to the customer when the product leaves our dock in Simi Valley, California, or another shipping location designated by us. Customers are allowed to return the product within thirty days of shipment if the product does not meet specifications.

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

Revenues from technical support services and other services are recognized at the time services are performed. Revenues from service contracts entered into with third party service providers are recognized at the time of the contract sale, net of costs.

### Marketable Securities

All of Qualstar's marketable securities were classified as available-for-sale as it is possible that some securities will be sold prior to maturity. 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.

### 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 annually). See "Note 6 – Financial Instruments."

### Allowance for Doubtful Accounts

We estimate our allowance for doubtful accounts based on an assessment of the collectibility 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.

13

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Index

## Share-Based 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, 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 materially impacted.

## Accounting for Income Taxes

We estimate our tax liability based on current tax laws in the statutory jurisdictions in which we operate. These estimates include judgments about deferred tax assets and liabilities resulting from temporary differences between assets and liabilities recognized for financial reporting purposes and such amounts recognized for tax purposes, as well as about the realization of deferred tax assets. See Note 11 – Income Taxes.

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.

## RESULTS OF OPERATIONS

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

	Three Months Ended			
	2009		September 30, 2008	
Net revenues	100.0	%	100.0	%
Cost of goods sold	73.8		65.1	
Gross profit	26.2		34.9	
Operating expenses:				
Research and development	21.8		13.8	
Sales and marketing	14.8		12.9	
General and administrative	18.2		14.2	
Total operating expenses	54.8		40.9	
Loss from operations	(28.6	)	(6.0	)
Investment income	2.8		5.2	
Loss before income taxes	(25.8	)	(0.8	)
Provision for income taxes	0.0		0.0	
Net loss	(25.8	)%	(0.8	)%

Index

We have two operating segments for financial reporting purposes: tape libraries and power supplies, as discussed in Note 12 of the Notes to Consolidated Financial Statements in Item 1 of this report. The following table summarizes our revenue by major product line and by operating segment:

	Three Months Ended September 30,	
	2009	2008
Tape Library revenues:		
TLS	19.7 %	23.6 %
RLS	4.8	9.4
XLS	7.9	8.1
	32.4	41.1
Other library revenues:		
Service	19.9	13.2
Media	11.5	11.8
Upgrades, spares	3.8	4.0
	35.2	29.0
<b>Total Library revenues</b>	<b>67.6</b>	<b>70.1</b>
<b>Power Supply revenues</b>	<b>32.4</b>	<b>29.9</b>
	100.0 %	100.0 %

#### Three Months Ended September 30, 2009 Compared to Three Months Ended September 30, 2008

**Net Revenue.** Net revenues decreased to \$3.7 million for the three months ended September 30, 2009 from \$5.4 million for the three months ended September 30, 2008, a decrease of \$1.7 million, or 31.9%. Two customers accounted for 11.8% and 10.8%, respectively, or 22.6% in the aggregate, of the Company's consolidated revenue for the three-month period ended September 30, 2009. The customers' accounts receivable balances, net of specific allowances, totaled approximately 5.7% and 15.0%, respectively, or 20.7% in the aggregate, of net accounts receivable as of September 30, 2009. Two customers accounted for 11.1% and 10.6%, respectively, or 21.7% in the aggregate, of the Company's consolidated revenue for the three-month period ended September 30, 2008. The customers' accounts receivable balances, net of specific allowances, totaled approximately 3.9% and 16.1%, respectively, or 20.0% in the aggregate, of net accounts receivable as of September 30, 2008.

#### Segment Revenue

**Tape Libraries** – Net tape library revenues decreased to \$2.5 million for the three months ended September 30, 2009 from \$3.8 million for the three months ended September 30, 2008, a decrease of \$1.3 million, or 34.3%. The decrease in revenues is attributed primarily to declines in revenues from each of our TLS, RLS and XLS tape library product lines, for a \$1.0 million aggregate decline in tape library revenues, and a \$0.3 million decline in miscellaneous and media revenues. Sales of our TLS tape libraries have declined in part because demand for libraries using AIT tape drives has continued to decline and we expect this trend to continue.

**Power Supplies** – Net revenues from power supplies decreased to \$1.2 million for the three months ended September 30, 2009 from \$1.6 million for the three months ended September 30, 2008, a decrease of \$0.4 million, or 26.2%. The decrease in revenues is attributed to lower sales to original equipment manufacturer customers.

**Gross Profit.** Gross profit represents the difference between our net revenues and cost of goods sold. Cost of goods sold consists primarily of purchased parts, direct and indirect labor costs, rent, technical support costs, depreciation of plant and equipment, utilities, and packaging costs. Gross profit decreased to \$1.0 million, or 26.2% of net revenues, for the three months ended September 30, 2009 from \$1.9 million, or 34.9% of net revenues, for the three months ended September 30, 2008. The decrease in gross profit is attributed to lower revenues, a change in product mix, an increase in inventory reserves, and lower absorption of labor and overhead.

Index

**Research and Development.** Research and development expenses consist of engineering salaries, benefits, outside consultant fees, and purchased parts and supplies used in development activities. Research and development expenses increased to \$0.8 million for the three months ended September 30, 2009 from \$0.7 million for the three months ended September 30, 2008. The increase of \$0.1 million, or 7.9% is primarily due to an increase in compensation related to additions in personnel and prototype material expenses.

**Sales and Marketing.** Sales and marketing expenses consist primarily of employee salaries and benefits, sales commissions, trade show costs, advertising and travel related expenses. Sales and marketing expenses decreased to \$0.5 million for the three months ended September 30, 2009 from \$0.7 million for the three months ended September 30, 2008. The decrease of \$0.2 million, or 21.7%, is primarily due to a decrease in compensation related to reductions in personnel and commission expenses.

**General and Administrative.** General and administrative expenses include employee salaries and benefits and professional service fees. General and administrative expenses decreased to \$0.7 million for the three months ended September 30, 2009 from \$0.8 million for the three months ended September 30, 2008. The decrease of \$0.1 million, or 12.4%, is primarily due to a decrease in compensation related to reductions in personnel and bad debt expenses.

**Investment Income.** Investment income decreased to \$0.1 million for the three months ended September 30, 2009 from \$0.3 million for the three months ended September 30, 2008. The decrease of \$0.2 million, or 63.2% is primarily due to the lower interest rate environment and partially due to having approximately \$4.5 million less cash and cash equivalents in the quarter ended September 30, 2009 compared to the prior year quarter.

**Provision for Income Taxes.** We did not record a provision or benefit for income taxes for the three months ended September 30, 2009. We recorded a benefit for income taxes of \$2,000 for the three months ended September 30, 2008.

## LIQUIDITY AND CAPITAL RESOURCES

Net cash used by operating activities was \$0.4 million in the three months ended September 30, 2009, primarily attributed to the net loss for the period and a decrease in accrued payroll and related liabilities, partially offset by a decrease in receivables and an increase in accounts payable. Net cash used by operating activities was \$0.5 million in the three months ended September 30, 2008, primarily attributed to increases in receivables, prepaid expenses and other assets, and a decrease in accrued payroll and related liabilities.

Cash used by investing activities was \$0.3 million in the three months ended September 30, 2009, primarily attributed to the purchase of marketable securities, partially offset by proceeds from the sale of marketable securities. Cash provided by investing activities was \$3.0 million in the three months ended September 30, 2008, primarily attributed to proceeds from the sale of marketable securities, partially offset by the purchase of marketable securities and the purchase of property and equipment.

Cash used in financing activities was \$0.7 million in the three months ended September 30, 2009, attributed to the payment of cash dividends of \$0.06 per share that we declared on August 28, 2009 and paid on September 28, 2009 on shares of our common stock. Cash used in financing activities was \$0.7 million during the three months ended September 30, 2008 for the payment of a cash dividend of \$0.06 per share that we declared on June 25, 2008 and paid on September 5, 2008.

As of September 30, 2009, we had \$2.4 million in cash and cash equivalents and \$24.1 million in marketable securities. We believe that our existing cash and cash equivalents and anticipated 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 at least the next 12 months. We may utilize cash to invest in businesses, products or technologies that we believe are strategic. We regularly evaluate other companies and technologies for possible investment 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 acquisition of other businesses or technologies.

Index

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

We develop products in the United States and sell them worldwide. 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 4T. CONTROLS AND PROCEDURES

We 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 Qualstar's disclosure controls and procedures as of September 30, 2009, pursuant to Rule 13a-15 under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms, and to ensure that the information required to be disclosed by us in reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

We did not make any changes in our internal control over financial reporting during the quarter ended September 30, 2009 of Qualstar's fiscal year ending June 30, 2010, that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Index

PART II — OTHER INFORMATION

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, 2009.

ITEM 6. EXHIBITS

Exhibit

No.	Exhibit Index
<u>31.1</u>	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>31.2</u>	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>32.1</u>	Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
<u>32.2</u>	Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Index

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: November 12, 2009

By: /s/ WILLIAM J. GERVAIS  
William J. Gervais  
Chief Executive Officer and  
President  
(Principal Executive Officer)