

QUALSTAR CORP  
Form 10-Q  
February 14, 2008

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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Form 10-Q

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

For the Quarterly Period Ended December 31, 2007

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):  
Large accelerated filer  Accelerated filer  Non-accelerated filer

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 December 31, 2007 is 12,253,117.

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QUALSTAR CORPORATION

FORM 10-Q  
 FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2007  
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## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

QUALSTAR CORPORATION  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (In thousands)

|   | December 31,<br>2007<br>(Unaudited) | June 30,<br>2007<br>(Audited) |
|---|-------------------------------------|-------------------------------|
| <b>ASSETS</b>   |                                     |                               |
| Current assets:   |                                     |                               |
| Cash and cash equivalents   | \$ 10,656                           | \$ 7,697                      |
| Marketable securities, short-term   | 8,145                               | 9,574                         |
| Receivables, net of allowances of \$183 at December 31, 2007, and \$170 at June 30, 2007  | 3,532                               | 3,462                         |
| Inventories, net  | 5,264                               | 5,928                         |
| Prepaid expenses and other current assets   | 659                                 | 576                           |
| Prepaid income taxes  | 134                                 | 137                           |
| Total current assets  | 28,390                              | 27,374                        |
| Property and equipment, net   | 538                                 | 601                           |
| Marketable securities, long-term  | 15,278                              | 15,994                        |
| Other assets  | 94                                  | 94                            |
| Total assets  | \$ 44,300                           | \$ 44,063                     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                                     |                               |
| Current liabilities:  |                                     |                               |
| Accounts payable  | \$ 954                              | \$ 654                        |
| Accrued payroll and related liabilities   | 469                                 | 455                           |
| Other accrued liabilities   | 1,092                               | 1,113                         |
| Total current liabilities   | 2,515                               | 2,222                         |
| Other long-term liabilities   | 45                                  | —                             |
| 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 at December 31, 2007 and June 30, 2007 | 18,653                              | 18,593                        |
| Accumulated other comprehensive income (loss)   | 85                                  | (55)                          |
| Retained earnings   | 23,002                              | 23,303                        |
| Total shareholders' equity  | 41,740                              | 41,841                        |
| Total liabilities and shareholders' equity  | \$ 44,300                           | \$ 44,063                     |

See the accompanying notes to these interim condensed consolidated financial statements.

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

|  | Three Months Ended<br>December 31, |           | Six Months Ended<br>December 31, |            |
|--|------------------------------------|-----------|----------------------------------|------------|
|  | 2007                               | 2006      | 2007                             | 2006       |
| Net revenues                           | \$ 6,049                           | \$ 5,283  | \$ 11,381                        | \$ 9,942   |
| Cost of goods sold                     | 4,004                              | 3,649     | 7,712                            | 7,006      |
| Gross profit                           | 2,045                              | 1,634     | 3,669                            | 2,936      |
| Operating expenses:                    |                                    |           |                                  |            |
| Research and development               | 770                                | 756       | 1,498                            | 1,507      |
| Sales and marketing                    | 840                                | 883       | 1,600                            | 1,650      |
| General and administrative             | 918                                | 812       | 1,656                            | 1,556      |
| Total operating expenses               | 2,528                              | 2,451     | 4,754                            | 4,713      |
| Loss from operations                   | (483)                              | (817)     | (1,085)                          | (1,777)    |
| Investment Income                      | 424                                | 371       | 837                              | 752        |
| Loss before income taxes               | (59)                               | (446)     | (248)                            | (1,025)    |
| Provision for income taxes             | —                                  | —         | 17                               | —          |
| Net loss                               | \$ (59)                            | \$ (446)  | \$ (265)                         | \$ (1,025) |
| Loss per share:                        |                                    |           |                                  |            |
| Basic                                  | \$ (0.00)                          | \$ (0.04) | \$ (0.02)                        | \$ (0.08)  |
| Diluted                                | \$ (0.00)                          | \$ (0.04) | \$ (0.02)                        | \$ (0.08)  |
| Shares used to compute loss per share: |                                    |           |                                  |            |
| Basic                                  | 12,253                             | 12,253    | 12,253                           | 12,253     |
| Diluted                                | 12,253                             | 12,253    | 12,253                           | 12,253     |

See the accompanying notes to these interim condensed consolidated financial statements.

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

|   | Six Months Ended<br>December 31, |            |
|---|----------------------------------|------------|
|   | 2007                             | 2006       |
| <b>OPERATING ACTIVITIES:</b>  |                                  |            |
| Net loss  | \$ (265)                         | \$ (1,025) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                                  |            |
| Share based compensation  | 60                               | 25         |
| Realized gain on marketable securities  | (2)                              | —          |
| Depreciation and amortization   | 153                              | 216        |
| (Recovery of) provision for bad debts and returns, net of recoveries                      | (11)                             | 31         |
| Changes in operating assets and liabilities:  |                                  |            |
| Accounts receivable   | (59)                             | (384)      |
| Inventories, net  | 664                              | 791        |
| Prepaid and other assets  | (83)                             | 15         |
| Prepaid income taxes  | 3                                | (7)        |
| Accounts payable  | 300                              | 90         |
| Accrued payroll and related liabilities   | 14                               | (44)       |
| Other accrued liabilities   | (12)                             | (157)      |
| Net cash provided by (used in) operating activities                                       | 762                              | (449)      |
| <b>INVESTING ACTIVITIES:</b>  |                                  |            |
| Purchases of property, equipment and leasehold improvements                               | (90)                             | (14)       |
| Proceeds from sale of marketable securities   | 16,874                           | 4,052      |
| Purchases of marketable securities  | (14,587)                         | (4,548)    |
| Net cash provided by (used in) investing activities                                       | 2,197                            | (510)      |
| Net change in cash and cash equivalents   | 2,959                            | (959)      |
| Cash and cash equivalents, beginning of period  | 7,697                            | 6,845      |
| Cash and cash equivalents, end of period  | \$ 10,656                        | \$ 5,886   |
| <b>Supplemental cash flow disclosure:</b>   |                                  |            |
| Income taxes paid   | \$ 7                             | \$ 7       |

See the accompanying notes to these interim condensed consolidated financial statements.

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QUALSTAR CORPORATION  
 CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
 SIX MONTHS ENDED DECEMBER 31, 2007  
 (Unaudited) (In thousands)

|   | Common Stock |           | Accumulated<br>Other           | Retained  | Total     |
|---|--------------|-----------|--------------------------------|-----------|-----------|
|   | Shares       | Amount    | Comprehensive<br>(Loss) Income | Earnings  |           |
| Balance at July 1, 2007                             | 12,253       | \$ 18,593 | \$ (55)                        | \$ 23,303 | \$ 41,841 |
| Share based compensation                            | —            | 60        | —                              | —         | 60        |
| Cumulative effect of change in accounting principle | —            | —         | —                              | (36)      | (36)      |
| Comprehensive loss:                                 |              |           |                                |           |           |
| Net loss  | —            | —         | —                              | (265)     | (265)     |
| Change in unrealized gains (losses) on investments  | —            | —         | 140                            | —         | 140       |
| Comprehensive loss                                  | —            | —         | —                              | —         | (125)     |
| Balance at December 31, 2007                        | 12,253       | \$ 18,653 | \$ 85                          | \$ 23,002 | \$ 41,740 |

See the accompanying notes to these condensed consolidated financial statements.

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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 condensed consolidated financial statements, including balance sheets and related interim statements of operations, 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 Management's Discussion and Analysis and the financial statements and notes thereto included in the Qualstar Corporation Annual Report on Form 10-K for the fiscal year ended June 30, 2007.

Basis of Consolidation

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

Note 2 – Loss Per Share

Qualstar calculates loss per share in accordance with Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share." Basic earnings 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.

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QUALSTAR CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The following table sets forth the computation of basic and diluted net loss per share for the three and six months ended December 31, 2007 and 2006:

|  | (In thousands, except per share amounts) |           |                                  |            |
|--|--|-----------|----------------------------------|------------|
|  | Three Months Ended<br>December 31,       |           | Six Months Ended<br>December 31, |            |
|  | 2007                                     | 2006      | 2007                             | 2006       |
| Net loss (a)   | \$ (59)                                  | \$ (446)  | \$ (265)                         | \$ (1,025) |
| 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)                             | \$ (0.00)                                | \$ (0.04) | \$ (0.02)                        | \$ (0.08)  |
| Diluted net loss per share (a)/(c)                           | \$ (0.00)                                | \$ (0.04) | \$ (0.02)                        | \$ (0.08)  |

Stock options are excluded for the three months and six months ended December 31, 2007, and 2006, from the computation of diluted loss per share as the effect would have been antidilutive.

#### Note 3 – Marketable Securities

Marketable securities consist primarily of high-quality U.S. corporate securities and U.S. federal government and state government debt securities. 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 December 31, 2007 and June 30, 2007.

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.

#### Note 4 – Inventories

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

|                    | December 31,<br>2007 | June 30,<br>2007 |
|--------------------|----------------------|------------------|
| Raw materials, net | \$ 4,820             | \$ 5,234         |

|                |    |       |    |       |
|----------------|----|-------|----|-------|
| Finished goods |    | 444   |    | 694   |
|                | \$ | 5,264 | \$ | 5,928 |

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## QUALSTAR CORPORATION

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

## Note 5 – Warranty Obligations

The Company follows the provisions of the Financial Accounting Standards Board (FASB) Interpretation No. 45 (“FIN 45”), Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others, which clarifies the requirements of Statement of Financial Accounting Standards (“SFAS”) No. 5, Accounting for Contingencies, relating to a guarantor’s accounting for disclosures for certain guarantees. FIN 45 requires enhanced disclosures, among other things, for certain guarantees, including warranty accruals. Qualstar does not issue third party guarantees, as defined, and therefore only the disclosure provisions of FIN 45 apply.

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

|                                 | Three Months<br>Ended<br>December 31,<br>2007 | Six Months<br>Ended<br>December 31,<br>2007 |
|---------------------------------|---|---|
| Beginning balance               | \$ 191  | \$ 174                                      |
| Cost of warranty claims         | (16)  | (35)  |
| Accruals for product warranties | 9   | 45  |
| Ending balance                  | \$ 184  | \$ 184                                      |

## Note 6 – Comprehensive Loss

For the six months ended December 31, 2007 and 2006, comprehensive loss amounted to approximately \$125,000 and \$764,000, 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 securities.

## Note 7 – 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 8 – Income Taxes

On July 1, 2007, the Company adopted the provisions of FIN 48, Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109, which provides a financial statement recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under FIN 48, 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 on 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. FIN 48 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.

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QUALSTAR CORPORATION

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

Adopting FIN 48 had the following impact on our financial statements: increased long-term liabilities by \$45,000, and reduced our retained earnings by \$36,000. In addition, \$144,000 was recorded as a FIN 48 contingent liability and offset against our net deferred tax assets. As of July 1, 2007, we had \$3.3 million of gross unrecognized tax benefits offset by a full valuation allowance. Thus, future changes in the unrecognized tax benefit will have no impact on our effective tax rate due to the existence of the valuation allowance. Our policy is to include interest and penalties on unrecognized tax benefits in income tax expense, but is not significant at December 31, 2007. The Company reasonably estimates that the unrecognized tax benefit will not change significantly within the next twelve months. The Company files its tax returns by the laws of the jurisdictions in which it operates. The Company's federal tax returns after 2002 and California tax returns after 2003 are still subject to examination. Various state jurisdictions tax years remain open to examination as well, though the Company believes any additional assessment will be immaterial to its consolidated financial statements.

Note 9 – Segment Information

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for reporting information about operating segments. This standard requires segmentation based on our internal organization and reporting of revenue and operating income based upon internal accounting methods. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our Chief Executive Officer. Our two segments are Tape Libraries and Power Supplies. The two segments discussed in this analysis are presented in the way we internally manage and monitor performance. Our financial reporting systems present various data for management to operate the business, including internal profit and loss statements prepared on a basis consistent with U.S. GAAP. The tape library business has dominated our operations, thus, our operations and reporting have been set up to accommodate a single segment and attribute all revenues and expenses to the tape library side, with the power supply business being an ancillary part of overall operations. As the power supply segment grew in the last two years to represent greater than 10% of combined revenues, a framework for internal resource allocations has been implemented for the three months and six months ended December 31, 2007 and December 31, 2006. 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 is not segregated between the two segments, but retained by the library segment.

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 for use in a wide variety of electronic equipment such as telecommunications equipment, machine tools, routers, switches, wireless systems and gaming devices.



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## QUALSTAR CORPORATION

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

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

|                      | Three Months<br>Ended December 31 |          | Six Months Ended<br>December 31, |          |
|----------------------|-----------------------------------|----------|----------------------------------|----------|
|                      | 2007                              | 2006     | 2007                             | 2006     |
| Revenue              |                                   |          |                                  |          |
| Tape Libraries:      |                                   |          |                                  |          |
| Product              | \$ 4,379                          | \$ 3,604 | \$ 8,331                         | \$ 6,751 |
| Service              | 624                               | 813      | 1,280                            | 1,538    |
| Total Tape Libraries | 5,003                             | 4,417    | 9,611                            | 8,289    |
| Power Supplies       | 1,046                             | 866      | 1,770                            | 1,653    |
| Consolidated Revenue | \$ 6,049                          | \$ 5,283 | \$ 11,381                        | \$ 9,942 |

|                                | Three Months Ended<br>December 31 |          | Six Months Ended<br>December 31, |            |
|--------------------------------|-----------------------------------|----------|----------------------------------|------------|
|                                | 2007                              | 2006     | 2007                             | 2006       |
| Income (Loss) before Taxes     |                                   |          |                                  |            |
| Tape Libraries                 | \$ (220)                          | \$ (499) | \$ (325)                         | \$ (1,089) |
| Power Supplies                 | 161                               | 53       | 60                               | 64         |
| Consolidated Loss before Taxes | \$ (59)                           | \$ (446) | \$ (265)                         | \$ (1,025) |

|                     | December 31<br>2007 | June 30,<br>2007 |
|---------------------|---------------------|------------------|
| Total Assets        |                     |                  |
| Tape Libraries      | \$ 43,378           | \$ 43,228        |
| Power Supplies      | 922                 | 835              |
| Consolidated Assets | \$ 44,300           | \$ 44,063        |

## Note 10 – Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS No. 157 defines fair value and provides guidance on measuring fair value in generally accepted accounting principles, and expands disclosure requirements associated with fair value. SFAS 157 is effective for our fiscal year beginning July 1, 2008. We do not expect the adoption of SFAS 157 to have a material impact on our financial statements.

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QUALSTAR CORPORATION

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

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 gives us the irrevocable option to carry many financial assets and liabilities at fair values, with changes in fair value recognized in earnings. SFAS No. 159 is effective for us beginning July 1, 2008, although early adoption is permitted. We do not expect the adoption of SFAS 159 to have a material impact on our financial statements.

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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, 2007 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 popular tape drive technologies including LTO (Linear Tape-Open tape format) and AIT (Advanced Intelligent Tape). We have discontinued sales of libraries with SAIT (Super Advanced Intelligent Tape), and DLT (Digital Linear Tape) tape drives due to declining demand for those tape drive technologies.

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 with theirs, which they sell as a complete system or solution. We assist our customers with marketing and technical support.

We also design, develop, manufacture and sell small high-efficiency open-frame switching power supplies for original equipment manufacturers of telecommunications equipment, servers, routers, switches, RAIDs, and other equipment. Our power supplies are sold under the N2Power brand name and private label brand names through independent sales representatives and distributors. The primary customers are original equipment manufacturers and contract manufacturers.

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.

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### 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) in accordance with SAB 104, Revenue Recognition. 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 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.

### 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.

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Share-Based Compensation

Share-based compensation is accounted for in accordance with SFAS 123R, "Share-Based Payment." 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 adopted Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48) in the first quarter of fiscal year 2008. See Note 8 – Income Taxes to the condensed consolidated financial statements included in this Form 10-Q for further discussion.

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

We 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.

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## RESULTS OF OPERATIONS

The following table sets forth certain financial data as a percentage of net revenues for the periods indicated:

|                                      | Three Months Ended |        | Six Months Ended |         |
|--------------------------------------|--------------------|--------|------------------|---------|
|                                      | December 31,       |        | December 31,     |         |
|                                      | 2007               | 2006   | 2007             | 2006    |
| Net revenues                         | 100.0%             | 100.0% | 100.0%           | 100.0%  |
| Cost of goods sold                   | 66.2               | 69.1   | 67.8             | 70.5    |
| Gross profit                         | 33.8               | 30.9   | 32.2             | 29.5    |
| Operating expenses:                  |                    |        |                  |         |
| Research and development             | 12.7               | 14.3   | 13.2             | 15.2    |
| Sales and marketing                  | 13.9               | 16.7   | 14.1             | 16.6    |
| General and administrative           | 15.2               | 15.4   | 14.6             | 15.7    |
| Total operating expenses             | 41.8               | 46.4   | 41.9             | 47.5    |
| Loss from operations                 | (8.0)              | (15.5) | (9.7)            | (18.0)  |
| Investment income                    | 7.0                | 7.0    | 7.4              | 7.6     |
| Loss before income taxes             | (1.0)              | (8.5)  | (2.3)            | (10.4)  |
| Provision (benefit) for income taxes | —                  | —      | 0.1              | —       |
| Net loss                             | (1.0)%             | (8.5)% | (2.4)%           | (10.4)% |

We have two operating segments for financial reporting purposes: tape libraries and power supplies, as discussed in Note 9 of the Notes to Condensed 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 |        | Six Months Ended |        |
|-------------------------|--------------------|--------|------------------|--------|
|                         | December 31        |        | December 31      |        |
|                         | 2007               | 2006   | 2007             | 2006   |
| Tape Library revenues:  |                    |        |                  |        |
| TLS                     | 33.1%              | 35.3%  | 32.9%            | 34.7%  |
| RLS                     | 10.6               | 6.8    | 10.8             | 8.5    |
| XLS                     | 8.8                | 5.7    | 7.7              | 5.4    |
|                         | 52.5               | 47.8   | 51.4             | 48.6   |
| Other library revenues: |                    |        |                  |        |
| Service                 | 10.3               | 15.4   | 11.3             | 15.5   |
| Media                   | 15.1               | 14.8   | 16.1             | 13.6   |
| Miscellaneous           | 4.8                | 5.6    | 5.7              | 5.7    |
|                         | 30.2               | 35.8   | 33.1             | 34.8   |
| Total Library revenues  | 82.7               | 83.6   | 84.4             | 83.4   |
| Power Supply revenues   | 17.3               | 16.4   | 15.6             | 16.6   |
|                         | 100.0%             | 100.0% | 100.0%           | 100.0% |

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Three Months Ended December 31, 2007 Compared to Three Months Ended December 31, 2006

**Net Revenue.** Net revenues increased to \$6.0 million for the three months ended December 31, 2007 from \$5.3 million for the three months ended December 31, 2006, an increase of \$0.7 million, or 14.5%. No single customer accounted for more than ten percent of the Company's consolidated revenue for the three month periods ended December 31, 2007 or December 31, 2006.

**Segment Revenue.** Revenues reported for the segments shown below are presented on a basis consistent with U.S. GAAP. Revenues reported in Note 9 – Segment Information, in Notes to Condensed Consolidated Financial Statements included in Item 1 of this report, are presented in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information.

**Tape Libraries –** Net revenues increased to \$5.0 million for the three months ended December 31, 2007 from \$4.4 million for the three months ended December 31, 2006, an increase of \$0.6 million, or 13.3%. The increase is attributed to higher revenues from our XLS, TLS and RLS tape libraries and from media, partially offset by lower service revenues. No single customer accounted for more than ten percent of tape library revenues for the three-month periods ended December 31, 2007 or December 31, 2006.

**Power Supplies –** Net revenues increased to \$1,046,000 for the three months ended December 31, 2007 from \$866,000 for the three months ended December 31, 2006, an increase of \$180,000, or 20.8%. The increase in revenues is attributed primarily to growth in sales to contract manufacturers. Two customers on a standalone basis accounted for 28.9%, and 15.0%, respectively, or 43.9% in the aggregate, of power supply sales for the three months ended December 31, 2007. Three customers on a standalone basis accounted for 36.0%, 16.5% and 13.1%, respectively, or 65.6% in the aggregate, of power supply sales for the three months ended December 31, 2006.

**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 increased to \$2.0 million for the three months ended December 31, 2007 from \$1.6 million for the three months ended December 31, 2006. The increase of \$0.4 million, or 25.2%, is primarily due to efficiencies achieved in material management.

**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 \$770,000 for the three months ended December 31, compared to \$756,000 for the three months ended December 31, 2006. The increase of \$14,000 or 1.9% is primarily due to higher prototype material and engineering salaries expenses, partially offset by lower consulting 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 \$840,000 for the three months ended December 31, 2007 from \$883,000 for the three months ended December 31, 2006. The decrease of \$42,000, or 4.8% is primarily due to the closure of our UK office and lower advertising and promotion expenses partially offset by increased commissions and recruitment expenses.

**General and Administrative.** General and administrative expenses include employee salaries and benefits and professional service fees. General and administrative expenses increased to \$918,000 for the three months ended December 31, 2007 from \$812,000 for the three months ended December 31, 2006. The increase of \$105,000, or 12.9% is primarily due to increased accounting consulting expenses attributed to Sarbanes Oxley compliance efforts partially offset by lower depreciation and amortization and bad debt expenses.

Investment Income. Investment income increased to \$424,000 for the three months ended December 31, 2007 from \$371,000 for the three months ended December 31, 2006. The increase of \$53,000, or 14.3% is primarily due to the reinvestment of proceeds from the maturities of longer-term securities into higher yielding securities.

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Provision (Benefit) for Income Taxes. We did not record a provision or benefit for income taxes for either the three months ended December 31, 2007 or for the three months ended December 31, 2006. We have recorded a full valuation allowance against our net deferred tax assets based on our assessment regarding the realizability of these net deferred tax assets in future periods.

Six Months Ended December 31, 2007 Compared to Six Months Ended December 31, 2006

Net Revenue. Net revenues increased to \$11.4 million for the six months ended December 31, 2007 from \$9.9 million for the six months ended December 31, 2006, an increase of \$1.4 million, or 14.5%. No single customer accounted for more than ten percent of the Company's consolidated revenue for the six-month periods ended December 31, 2007 and December 31, 2006.

Segment Revenue. Revenues reported for the segments shown below are presented on a basis consistent with U.S. GAAP. Revenues reported in Note 9 – Segment Information, in Notes to Condensed Consolidated Financial Statements included in Item 1 of this report, are presented in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information.

Tape Libraries – Net revenues increased to \$9.6 million for the six months ended December 31, 2007 from \$8.3 million for the six months ended December 31, 2006, an increase of \$1.3 million, or 15.9%. The increase in revenues is attributed to higher revenues from our XLS, TLS and RLS tape libraries and from media, partially offset by lower service revenues. No single customer accounted for more than ten percent of tape library revenues for the six-month periods ended December 31, 2007 or December 31, 2006.

Power Supplies – Net revenues increased to \$1.8 million for the six months ended December 31, 2007 from \$1.7 million for the six months ended December 31, 2006, an increase of \$0.1 million, or 7.1%. The increase in revenues is attributed primarily to growth in sales to contract manufacturers. Two customers on a standalone basis accounted for 20.9% and 14.3%, respectively, or 35.2% in the aggregate, of power supply sales for the six months ended December 31, 2007. Two customers on a standalone basis accounted for 29.1% and 13.4%, respectively, or 42.5% in the aggregate, of power supply sales for the six months ended December 31, 2006.

Gross Profit. Gross profit increased to \$3.7 million for the six months ended December 31, 2007 from \$2.9 million for the six months ended December 31, 2006. The increase of \$0.7 million, or 25.0%, is primarily due to efficiencies achieved in material management.

Research and Development. Research and development expenses remained comparable at \$1.5 million for the six months ended December 31, 2007 and for the six months ended December 31, 2006.

Sales and Marketing. Sales and marketing expenses decreased to \$1.6 million for the six months ended December 31, 2007 from \$1.7 million for the six months ended December 31, 2006. The decrease of \$0.1 million, or 3.0% is primarily due to closure of our United Kingdom office and lower advertising and promotion expenses partially offset by increased commissions, travel and recruitment expenses.

General and Administrative. General and administrative expenses increased to \$1.7 million for the six months ended December 31, 2007 from \$1.6 million for the six months ended December 31, 2006. The increase of \$0.1 million, or 6.4% is primarily due to increased salaries and related expenses and accounting consulting expenses attributed to Sarbanes Oxley compliance efforts partially offset by lower depreciation and amortization and bad debt expenses.

Investment Income. Investment income increased to \$837,000 for the six months ended December 31, 2007 from \$752,000 for the six months ended December 31, 2006. The increase of \$85,000, or 11.3% is primarily due to the reinvestment of proceeds from the maturities of longer-term securities into higher yielding securities.

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Provision (Benefit) for Income Taxes. We recorded a provision for income taxes of \$17,000 for the six months ended December 31, 2007 relating to state income taxes paid during the three months ended September 30, 2007 and interest expense accrued as part of our liability resulting from our adoption on July 1, 2007 of FIN 48, Accounting for Uncertainties in Income Taxes – an Interpretation of FASB Statement No. 109. See Note 8 of Notes to Condensed Consolidated Financial Statements in Item 1 of this report for a further discussion of FIN 48. We did not record a provision or benefit for income taxes for the six months ended December 31, 2006.

#### LIQUIDITY AND CAPITAL RESOURCES

Cash provided by operating activities was \$762,000 in the six months ended December 31, 2007, primarily attributed to a decrease in inventories and an increase in accounts payable, partially offset by an increase in prepaids and other assets and the net loss from operations. Cash used in operating activities was \$449,000 in the six months ended December 31, 2006, primarily attributed to the net loss from operations and an increase in receivables, partially offset by a decrease in inventories and prepaids and other assets, and an increase in accounts payable.

Cash provided by investing activities was \$2.2 million in the six months ended December 31, 2007, primarily attributed to the sale of marketable securities, partially offset by the purchase of marketable securities and the purchase of fixed assets. Cash used in investing activities was \$510,000 in the six months ended December 31, 2006, primarily attributed to the purchase of marketable securities, partially offset by the sale of marketable securities.

Cash was not used in or provided by financing activities during the six months ended December 31, 2007 or the six months ended December 31, 2006.

As of December 31, 2007, we had \$10.7 million in cash and cash equivalents and \$23.4 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.

#### 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 December 31, 2007, 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.

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We did not make any changes in our internal control over financial reporting during the quarter ended December 31, 2007 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 6. EXHIBITS

| Exhibit No. | Exhibit Index   |
|-------------|---|
| <u>3.2</u>  | Bylaws, as amended and restated January 14, 2000.   |
| <u>3.3</u>  | Amendment to Bylaws, adopted December 21, 2007.   |
| <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. |

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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: February 14, 2008

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

By: /s/ ANDREW A. FARINA  
Andrew A. Farina  
Chief Financial Officer  
(Principal Financial Officer)