

QUALSTAR CORP  
Form 10-Q  
May 13, 2010

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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 March 31, 2010

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

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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 March 31, 2010 is 12,253,117.

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QUALSTAR CORPORATION  
FORM 10-Q  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2010  
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## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

QUALSTAR CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands)

|   | March 31,<br>2010<br>(Unaudited) | June 30,<br>2009<br>(Audited) |
|---|----------------------------------|-------------------------------|
| <b>ASSETS</b>   |                                  |                               |
| Current assets:   |                                  |                               |
| Cash and cash equivalents   | \$1,230                          | \$3,749                       |
| Marketable securities, short-term   | 13,011                           | 16,856                        |
| Receivables, net of allowances of \$62 at March 31, 2010, and \$85 at June 30, 2009   | 2,745                            | 2,305                         |
| Inventories, net  | 5,031                            | 5,822                         |
| Prepaid expenses and other current assets   | 327                              | 397                           |
| Total current assets  | 22,344                           | 29,129                        |
| Property and equipment, net   | 284                              | 361                           |
| Marketable securities, long-term  | 10,529                           | 7,056                         |
| Other assets  | 46                               | 46                            |
| Total assets  | \$33,203                         | \$36,592                      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                                  |                               |
| Current liabilities:  |                                  |                               |
| Accounts payable  | \$1,409                          | \$649                         |
| Accrued payroll and related liabilities   | 412                              | 505                           |
| Other accrued liabilities   | 944                              | 894                           |
| Total current liabilities   | 2,765                            | 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 March 31, 2010 and June 30, 2009 | 18,822                           | 18,798                        |
| Accumulated other comprehensive income  | 54                               | 168                           |
| Retained earnings   | 11,528                           | 15,544                        |
| Total shareholders' equity  | 30,404                           | 34,510                        |
| Total liabilities and shareholders' equity  | \$33,203                         | \$36,592                      |

See notes to condensed consolidated financial statements.



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

|  | Three Months Ended<br>March 31, |           | Nine Months Ended<br>March 31, |            |
|--|---------------------------------|-----------|--------------------------------|------------|
|  | 2010                            | 2009      | 2010                           | 2009       |
| Net Revenues                                   | \$4,003                         | \$4,098   | \$11,279                       | \$14,123   |
| Cost of goods sold                             | 2,797                           | 2,694     | 7,916                          | 9,362      |
| Gross profit                                   | 1,206                           | 1,404     | 3,363                          | 4,761      |
| Operating expenses:                            |                                 |           |                                |            |
| Research and development                       | 790                             | 807       | 2,401                          | 2,315      |
| Sales and marketing                            | 598                             | 679       | 1,766                          | 2,127      |
| General and administrative                     | 685                             | 842       | 2,001                          | 2,410      |
| Total operating expenses                       | 2,073                           | 2,328     | 6,168                          | 6,852      |
| Loss from operations                           | (867 )                          | (924 )    | (2,805 )                       | (2,091 )   |
| Investment Income                              | 70                              | 210       | 259                            | 781        |
| Loss before income taxes                       | (797 )                          | (714 )    | (2,546 )                       | (1,310 )   |
| Benefit for income taxes                       | -                               | 6         | -                              | 4          |
| Net loss                                       | \$(797 )                        | \$(720 )  | \$(2,546 )                     | \$(1,314 ) |
| Loss per common share:                         |                                 |           |                                |            |
| Basic and Diluted                              | \$(0.07 )                       | \$(0.06 ) | \$(0.21 )                      | \$(0.11 )  |
| Weighted average common shares<br>outstanding: |                                 |           |                                |            |
| Basic and Diluted                              | 12,253                          | 12,253    | 12,253                         | 12,253     |
| Cash dividends declared per common share       | \$0.00                          | \$0.06    | \$0.12                         | \$0.18     |

See notes to condensed consolidated financial statements.

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

|   | Nine Months Ended<br>March 31, |                |
|---|--------------------------------|----------------|
|   | 2010                           | 2009           |
| <b>OPERATING ACTIVITIES:</b>  |                                |                |
| Net loss  | \$(2,546)                      | \$(1,314)      |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                                |                |
| Depreciation and amortization   | 131                            | 174            |
| (Recovery of) provision for bad debts and returns, net                                    | (26)                           | 55             |
| Provision for (recovery of) inventory reserve   | 136                            | (127)          |
| Stock based compensation  | 24                             | 68             |
| Loss (gain) on sale of securities   | 2                              | (98)           |
| Changes in operating assets and liabilities:  |                                |                |
| Accounts receivable   | (414)                          | 729            |
| Inventories   | 655                            | (644)          |
| Prepaid expenses and other assets   | 70                             | 39             |
| Accounts payable  | 760                            | (243)          |
| Accrued payroll and related liabilities   | (93)                           | (109)          |
| Other accrued liabilities   | 50                             | (173)          |
| Net cash used in operating activities   | (1,251)                        | (1,643)        |
| <b>INVESTING ACTIVITIES:</b>  |                                |                |
| Purchases of equipment  | (54)                           | (62)           |
| Purchases of marketable securities  | (13,617)                       | (26,243)       |
| Proceeds from the sale of marketable securities   | 13,873                         | 25,749         |
| Net cash provided by (used in) investing activities                                       | 202                            | (556)          |
| <b>FINANCING ACTIVITIES:</b>  |                                |                |
| Cash dividends on common shares   | (1,470)                        | (2,205)        |
| Net cash used in financing activities   | (1,470)                        | (2,205)        |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>  | <b>(2,519)</b>                 | <b>(4,404)</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>\$1,230</b>                 | <b>\$2,340</b> |
| <b>SUPPLEMENTAL CASH FLOW DISCLOSURES:</b>  |                                |                |
| Income taxes paid   | \$10                           | \$11           |

See notes to condensed consolidated financial statements.

QUALSTAR CORPORATION  
 CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
 NINE MONTHS ENDED MARCH 31, 2010  
 (Unaudited) (In thousands)

|  | Common Stock |          | Accumulated<br>Other<br>Comprehensive<br>Income | Retained<br>Earnings | Total    |
|--|--------------|----------|---|----------------------|----------|
|  | Shares       | Amount   |   |                      |          |
| Balance at June 30, 2009                   | 12,253       | \$18,798 | \$168   | \$15,544             | \$34,510 |
| Share-based compensation                   | —            | 24       | —   | —                    | 24       |
| Cash dividend on common shares             | —            | —        | —   | (1,470)              | (1,470)  |
| Comprehensive loss:                        |              |          |   |                      |          |
| Net loss                                   | —            | —        | —   | (2,546)              | (2,546)  |
| Change in unrealized losses on investments | —            | —        | (114)   | —                    | (114)    |
| Comprehensive Loss                         | —            | —        | —   | —                    | (2,660)  |
| Balance at March 31, 2010                  | 12,253       | \$18,822 | \$54  | \$11,528             | \$30,404 |

See notes to condensed consolidated financial statements



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 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 Qualstar Corporation, effective June 30, 2009, assumed all liabilities of Qualstar Sales and Service Corporation.

Note 2 – Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

In February 2010, the FASB issued ASU 2010-09 to amend the disclosure requirements related to subsequent events. The guidance requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities traded in a public market is required to evaluate subsequent events through the date that the financial statements are issued. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated.

In January 2010, the FASB issued an Accounting standards Update ("ASU") 2010-06, to amend the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on

the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance became effective for us with the reporting period beginning January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, adoption of this new guidance did not have a material impact on our financial statements.

QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS- (Continued)

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, FASB ASC 820, 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.

On July 1, 2009 we adopted the authoritative guidance issued by the Financial Accounting Standards Board (“FASB”) on business combinations, FASB ASC 805. 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 non-controlling interests. Noncontrolling interests 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 that 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, ASU 2009-13 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.

## QUALSTAR CORPORATION

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

## 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 36.1% of net revenues in the three months ended March 31, 2010, and 21.3% of net revenues in the three months ended March 31, 2009. Sales outside of North America represented approximately 33.0% of net revenues in the nine months ended March 31, 2010, and 26.0% of net revenues in the nine months ended March 31, 2009.

One customer accounted for 15.3% of the Company's consolidated revenue for the three-month period ended March 31, 2010. The customer's accounts receivable balance, net of specific allowances, totaled approximately 17.0% of net accounts receivable. One customer accounted for 11.6% of the Company's consolidated revenue for the three-month period ended March 31, 2009. The customer's accounts receivable balance, net of specific allowances, totaled approximately 12.2% of net accounts receivable.

One customer accounted for 10.9% of the Company's consolidated revenue for the nine-month period ended March 31, 2010. The customer's accounts receivable balance, net of specific allowances, totaled approximately 17.0% of net accounts receivable. One customer accounted for 11.2% of the Company's consolidated revenue for the nine-month period ended March 31, 2009. The customer's accounts receivable balance, net of specific allowances, totaled approximately 3.0% of net accounts receivable.

Sales and costs of goods sold related to tape library products only available from one supplier totaled approximately 6.3% and 6.6% for the three months ended March 31, 2010 and 15.1% and 20.9% for the three months ended March 31, 2009, respectively, of total sales and cost of goods sold. Sales and costs of goods sold related to tape library products only available from one supplier totaled approximately 8.4% and 9.4% for the nine months ended March 31, 2010 and 15.5% and 19.8% for the nine months ended March 31, 2009, 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:

|  | Three Months Ended |      | Nine Months Ended |      |
|--|--------------------|------|-------------------|------|
|  | March 31,          |      | March 31,         |      |
| In thousands (except per share amounts): | 2010               | 2009 | 2010              | 2009 |

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|  |          |   |          |   |           |   |           |   |
|--|----------|---|----------|---|-----------|---|-----------|---|
| Net loss (a)   | \$ (797  | ) | \$ (720  | ) | \$ (2,546 | ) | \$ (1,314 | ) |
| 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)                             | \$ (0.07 | ) | \$ (0.06 | ) | \$ (0.21  | ) | \$ (0.11  | ) |
| Diluted net loss per share (a)/(c)                           | \$ (0.07 | ) | \$ (0.06 | ) | \$ (0.21  | ) | \$ (0.11  | ) |

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## QUALSTAR CORPORATION

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

Stock options are excluded for the three and nine-month periods ended March 31, 2010 and 2009, 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, asset-backed 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 that Qualstar has the ability and intent to hold until maturity. All other securities not included in trading or held-to-maturity is classified as available-for-sale. All of Qualstar's marketable securities were classified as available-for-sale at March 31, 2010 and June 30, 2009.

The following tables summarize the marketable securities by security type at March 31, 2010, and June 30, 2009, respectively (in thousands):

| March 31, 2010                                       | Amortized Cost | Unrealized Gain | Unrealized Loss | Fair Value | Short-term Securities | Long-term Securities |
|--|----------------|-----------------|-----------------|------------|-----------------------|----------------------|
| US Treasury obligations and U.S. Government agencies | \$18,475       | \$50            | \$—             | \$18,525   | \$11,174              | \$7,350              |
| Collateralized mortgage obligations                  | 746            | 7               | —               | 753        | 753                   | —                    |
| Asset-backed securities                              | 1,978          | 1               | —               | 1,978      | —                     | 1,978                |
| Corporate bonds                                      | 2,287          | —               | (3)             | 2,284      | 1,084                 | 1,200                |
| Total  | \$23,486       | \$58            | \$(3)           | \$23,540   | \$13,011              | \$10,528             |

| June 30, 2009  | Amortized Cost | Unrealized Gain | Unrealized Loss | Fair Value | Short-term Securities | Long-term Securities |
|--|----------------|-----------------|-----------------|------------|-----------------------|----------------------|
| US Treasury obligations and U.S. Government agencies | \$20,616       | \$119           | \$—             | \$20,735   | \$14,110              | \$6,625              |
| Collateralized mortgage obligations                  | 2,376          | 47              | —               | 2,423      | 1,992                 | 431                  |
| Corporate bonds                                      | 752            | 2               | —               | 754        | 754                   | —                    |
| Total  | \$23,744       | \$168           | \$—             | \$23,912   | \$16,856              | \$7,056              |

There were no unrealized loss positions as of June 30, 2009. The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2010 (in thousands):

| March 31, 2010  | Less Than 12 Months Fair Value | Unrealized Loss | 12 Months or Greater Fair Value | Unrealized Loss | Total Fair Value | Unrealized Loss |
|-----------------|--------------------------------|-----------------|---------------------------------|-----------------|------------------|-----------------|
| Corporate bonds | 2,284                          | (3)             | —                               | —               | 2,284            | (3)             |
| Total           | \$2,284                        | \$(3)           | \$—                             | \$—             | \$2,284          | \$(3)           |

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-sales 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. (Loss) gain on the sale of marketable securities for the three months ended March 31, 2010 and 2009 was (\$1,000) and \$35,000, respectively. (Loss) gain on the sale of securities for the nine months ended March 31, 2010 and 2009 was (\$2,000) and \$98,000, respectively. The change in net unrealized holding (loss) gain on available-for-sale securities that has been included in the other comprehensive income of shareholder's equity during the nine months ended March 31, 2010 and 2009 was (\$114,000) and \$83,000, respectively.



## Note 6 – Fair Value Measurements

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 March 31, 2010 does not contain direct exposure to sub prime mortgages or structured vehicles that derive their value from sub prime 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 March 31, 2010 (in thousands):

| Assets                                | Level 1 | Level 2 | Net Balance |
|---------------------------------------|---------|---------|-------------|
| Cash                                  | \$ 610  | –       | \$ 610      |
| Money Market Mutual fund              | 620     | –       | 620         |
| U.S. government and agency securities | 10,286  | 8,239   | 18,525      |
| Asset-backed securities               | –       | 1,978   | 1,978       |
| Mortgage-backed securities            | –       | 753     | 753         |

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|                 |                  |                  |                  |
|-----------------|------------------|------------------|------------------|
| Corporate bonds | -                | 2,284            | 2,284            |
| <b>Total</b>    | <b>\$ 11,516</b> | <b>\$ 13,254</b> | <b>\$ 24,770</b> |

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):

|                         | March 31, 2010 | June 30, 2009 |
|-------------------------|----------------|---------------|
| Raw materials           | \$ 4,850       | \$ 5,389      |
| Finished goods          | 1,139          | 1,248         |
| Subtotal                | 5,989          | 6,637         |
| Less: Inventory reserve | (958 )         | (815 )        |
| Net inventory balance   | \$ 5,031       | \$ 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 for tape libraries generally include parts and labor over a three-year period. The warranty for power supplies generally is two years. 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):

|                                 | Nine Months Ended<br>March 31, |        |
|---------------------------------|--------------------------------|--------|
|                                 | 2010                           | 2009   |
| Beginning balance               | \$ 167                         | \$ 180 |
| Cost of warranty claims         | (48 )                          | (47 )  |
| Accruals for product warranties | 39                             | 38     |
| Ending balance                  | \$ 158                         | \$ 171 |

## Note 9 – Comprehensive Loss

For the nine months ended March 31, 2010 and 2009, comprehensive loss amounted to approximately \$2,660,000 and \$1,231,000, 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, and 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 nine months ended March 31, 2010. We recorded a provision for income taxes of \$4,000 for the nine months ended March 31, 2009.

## 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 nine months ended March 31, 2010 and 2009. Allocations for internal resources were made for the nine months ended March 31, 2010 and 2009. The power supplies segment tracks certain assets separately, 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<br>March 31, |         | Nine Months Ended<br>March 31, |           |
|----------------------------|---------------------------------|---------|--------------------------------|-----------|
|                            | 2010                            | 2009    | 2010                           | 2009      |
| Revenue                    |                                 |         |                                |           |
| Tape Libraries:            |                                 |         |                                |           |
| Product                    | \$1,387                         | \$2,325 | \$5,054                        | \$7,922   |
| Service                    | 722                             | 742     | 2,169                          | 2,079     |
| Total Tape Libraries       | 2,109                           | 3,067   | 7,223                          | 10,001    |
| Power Supplies             | 1,894                           | 1,031   | 4,056                          | 4,122     |
| Consolidated Revenue       | \$4,003                         | \$4,098 | \$11,279                       | \$14,123  |
|                            |                                 |         |                                |           |
|                            | Three Months Ended<br>March 31, |         | Nine Months Ended<br>March 31, |           |
|                            | 2010                            | 2009    | 2010                           | 2009      |
| Income (Loss) before Taxes |                                 |         |                                |           |
| Tape Libraries             | \$(992)                         | \$(638) | \$(2,499)                      | \$(1,424) |

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|                                |        |     |        |     |          |     |          |   |
|--------------------------------|--------|-----|--------|-----|----------|-----|----------|---|
| Power Supplies                 | 195    | (76 | )      | (47 | )        | 114 |          |   |
| Consolidated Loss before Taxes | \$(797 | )   | \$(714 | )   | \$(2,546 | )   | \$(1,310 | ) |

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QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS- (Continued)

|                     | March 31,<br>2010 | June 30, 2009 |
|---------------------|-------------------|---------------|
| Total Assets        |                   |               |
| Tape Libraries      | \$33,389          | \$37,172      |
| Power Supplies      | (186 )            | (580 )        |
| Consolidated Assets | \$33,203          | \$36,592      |

Note 13 – Subsequent Event

The Company has performed an evaluation of subsequent events through the date of filing.

## 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.





## 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.

## 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<br>March 31, |    |       |    | Nine Months Ended<br>March 31, |    |       |    |
|----------------------------|---------------------------------|----|-------|----|--------------------------------|----|-------|----|
|                            | 2010                            |    | 2009  |    | 2010                           |    | 2009  |    |
| Net revenues               | 100.0                           | %  | 100.0 | %  | 100.0                          | %  | 100.0 | %  |
| Cost of goods sold         | 69.9                            |    | 65.7  |    | 70.2                           |    | 66.3  |    |
| Gross profit               | 30.1                            |    | 34.3  |    | 29.8                           |    | 33.7  |    |
| Operating expenses:        |                                 |    |       |    |                                |    |       |    |
| Research and development   | 19.7                            |    | 19.7  |    | 21.3                           |    | 16.4  |    |
| Sales and marketing        | 14.9                            |    | 16.6  |    | 15.7                           |    | 15.1  |    |
| General and administrative | 17.1                            |    | 20.5  |    | 17.7                           |    | 17.1  |    |
| Total operating expenses   | 51.7                            |    | 56.8  |    | 54.7                           |    | 48.6  |    |
| Loss from operations       | (21.6                           | )  | (22.5 | )  | (24.9                          | )  | (14.9 | )  |
| Investment income          | 1.7                             |    | 5.1   |    | 2.3                            |    | 5.5   |    |
| Loss before income taxes   | (19.9                           | )  | (17.4 | )  | (22.6                          | )  | (9.4  | )  |
| Provision for income taxes | 0.0                             |    | 0.1   |    | 0.0                            |    | 0.0   |    |
| Net loss                   | (19.9                           | )% | (17.5 | )% | (22.6                          | )% | (9.4  | )% |



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<br>March 31, |         | Nine Months Ended<br>March 31, |         |
|-------------------------|---------------------------------|---------|--------------------------------|---------|
|                         | 2010                            | 2009    | 2010                           | 2009    |
| Tape Library revenues:  |                                 |         |                                |         |
| TLS                     | 9.0                             | % 20.9  | % 15.3                         | % 23.5  |
| RLS                     | 4.7                             | 6.1     | 5.2                            | 7.0     |
| XLS                     | 13.5                            | 7.5     | 14.6                           | 6.9     |
|                         | 27.2                            | 34.5    | 35.1                           | 37.4    |
| Other library revenues: |                                 |         |                                |         |
| Service                 | 18.0                            | 18.1    | 19.2                           | 14.7    |
| Media                   | 4.4                             | 16.4    | 6.5                            | 13.8    |
| Upgrades, spares        | 3.0                             | 5.8     | 3.2                            | 4.9     |
|                         | 25.4                            | 40.3    | 28.9                           | 33.4    |
| Total Library revenues  | 52.7                            | 74.8    | 64.0                           | 70.8    |
| Power Supply revenues   | 47.3                            | 25.2    | 36.0                           | 29.2    |
|                         | 100.0                           | % 100.0 | % 100.0                        | % 100.0 |

#### Three Months Ended March 31, 2010 Compared to Three Months Ended March 31, 2009

**Net Revenue.** Net revenues decreased to \$4.0 million for the three months ended March 31, 2010 from \$4.1 million for the three months ended March 31, 2009, a decrease of \$0.1 million, or 2.3%. One customer accounted for 15.3% of the Company's consolidated revenue for the three-month period ended March 31, 2010. The customer's accounts receivable balance, net of specific allowances, totaled approximately 17.0% of net accounts receivable. One customer accounted for 11.6% of the Company's consolidated revenue for the three-month period ended March 31, 2009. The customer's accounts receivable balance, net of specific allowances, totaled approximately 12.2% of net accounts receivable as of March 31, 2009.

#### Segment Revenue

**Tape Libraries –** Net tape library revenues decreased to \$2.1 million for the three months ended March 31, 2010 from \$3.1 million for the three months ended March 31, 2009, a decrease of \$1.0 million, or 31.2%. The decrease in revenues is attributed primarily to a \$0.5 million decline in revenues from our TLS product line, a \$0.5 million decline in sales of tape media, a \$0.1 million decline in revenues from our RLS product line and a \$0.1 million decline in miscellaneous revenues, offset in part by a \$0.2 million increase in revenues from our XLS product line.

**Power Supplies –** Net revenues from power supplies increased to \$1.9 million for the three months ended March 31, 2010 from \$1.0 million for the three months ended March 31, 2009, an increase of \$0.9 million, or 83.7%. The increase in revenues is attributed to higher sales to original equipment manufacturer customers and distributors.

**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 \$1.2 million, or 30.1% of net revenues,

for the three months ended March 31, 2010 from \$1.4 million, or 34.3% of net revenues, for the three months ended March 31, 2009. The decrease in gross profit percentage is attributed to a change in product mix, an increase in inventory reserves, and lower absorption of labor and overhead.

**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 remained comparable at \$0.8 million for the three months ended March 31, 2010 and the three months ended March 31, 2009.

**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 \$0.6 million for the three months ended March 31, 2010 from \$0.7 million for the three months ended March 31, 2009. The decrease of \$0.1 million, or 11.9%, is primarily due to a decrease in advertising and promotion and miscellaneous 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 March 31, 2010 from \$0.8 million for the three months ended March 31, 2009. The decrease of \$0.1 million, or 18.6%, is primarily due to a decrease in compensation related to reductions in personnel and bad debt expense, partially offset by an increase in legal expense.

**Investment Income.** Investment income decreased to \$0.1 million for the three months ended March 31, 2010 from \$0.2 million for the three months ended March 31, 2009. The decrease of \$0.1 million, or 66.7% is primarily due to the lower interest rate environment and partially due to having approximately \$4.0 million less cash, cash equivalents and marketable securities in the quarter ended March 31, 2010 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 March 31, 2010. We recorded a provision for income taxes of \$6,000 for the three months ended March 31, 2009.

#### Nine Months Ended March 31, 2010 Compared to Nine Months Ended March 31, 2009

**Net Revenue.** Net revenues decreased to \$11.3 million for the nine months ended March 31, 2010 from \$14.1 million for the nine months ended March 31, 2009, a decrease of \$2.8 million, or 20.1%. One customer accounted for 10.9% of the Company's consolidated revenue for the nine-month period ended March 31, 2010. The customer's accounts receivable balance, net of specific allowances, totaled approximately 17.0% of net accounts receivable. One customer accounted for 11.2% of the Company's consolidated revenue for the nine-month period ended March 31, 2009. The customer's accounts receivable balance, net of specific allowances, totaled approximately 3.0% of net accounts receivable as of March 31, 2009.

#### Segment Revenue

**Tape Libraries –** Net tape library revenues decreased to \$7.2 million for the nine months ended March 31, 2010 from \$10.0 million for the nine months ended March 31, 2009, a decrease of \$2.8 million, or 27.8%. The decrease in revenues is attributed primarily to a \$2.0 million decline in revenues from our TLS and RLS product lines and a \$1.5 million decline in revenues from tape media and miscellaneous items, partially offset by a \$0.7 million increase in revenues from our XLS product line.

**Power Supplies –** Net revenues from power supplies remained comparable at \$4.1 million for the nine months ended March 31, 2010 and the nine months ended March 31, 2009.

**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 \$3.4 million, or 29.8% of net revenues, for the nine months ended March 31, 2010 from \$4.8 million, or 33.7% of net revenues, for the nine months ended



March 31, 2009. The decrease in gross profit is attributed to lower revenues, lower absorption of labor and overhead and an increase in inventory reserves.

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 \$2.4 million for the nine months ended March 31, 2010 from \$2.3 million for the nine months ended March 31, 2009. The increase of \$0.1 million, or 3.7% is primarily due to an increase in consulting fees 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 \$1.8 million for the nine months ended March 31, 2010 from \$2.1 million for the nine months ended March 31, 2009. The decrease of \$0.3 million, or 17.0%, is primarily due to decreases in compensation related to reductions in personnel, commission expenses, advertising and promotion and sales consulting expenses.

**General and Administrative.** General and administrative expenses include employee salaries and benefits and professional service fees. General and administrative expenses decreased to \$2.0 million for the nine months ended March 31, 2010 from \$2.4 million for the nine months ended March 31, 2009. The decrease of \$0.4 million, or 17.0%, is primarily due to a decrease in compensation related to reductions in personnel and bad debt expenses, partially offset by an increase in legal expense.

**Investment Income.** Investment income decreased to \$0.3 million for the nine months ended March 31, 2010 from \$0.8 million for the nine months ended March 31, 2009. The decrease of \$0.5 million, or 66.8% is primarily due to the lower interest rate environment and partially due to having approximately \$4.0 million less cash, cash equivalents and marketable securities in the nine months ended March 31, 2010 compared to the nine months ended March 31, 2009.

**Provision for Income Taxes.** We did not record a provision or benefit for income taxes for the nine months ended March 31, 2010. We recorded a provision for income taxes of \$4,000 for the nine months ended March 31, 2009.

## LIQUIDITY AND CAPITAL RESOURCES

Net cash used by operating activities was \$1.2 million in the nine months ended March 31, 2010, primarily attributed to the net loss for the period and an increase in accounts receivable, partially offset by a decrease in inventories and an increase in accounts payable. Net cash used by operating activities was \$1.6 million in the nine months ended March 31, 2009, primarily attributed to the net loss for the period, an increase in inventories and a decrease in accounts payable, other accrued liabilities and accrued payroll and related liabilities, partially offset by a decrease in receivables.

Cash provided by investing activities was \$0.2 million in the nine months ended March 31, 2010, primarily attributed to the sale of marketable securities, partially offset by the purchase of marketable securities. Cash used in investing activities was \$0.5 million in the nine months ended March 31, 2009, primarily attributed to the purchase of marketable securities, partially offset by the sale of marketable securities.

Cash used in financing activities was \$1.5 million in the nine months ended March 31, 2010, attributed to the payment of cash dividends of \$0.06 per share of our common stock in each of the first and second quarters of fiscal 2010. Cash used in financing activities during the nine months ended March 31, 2009 was \$2.2 million, attributed to the payment of cash dividends of \$0.06 per share of our common stock in each of the first, second and third quarters of fiscal 2009.

As of March 31, 2010, we had \$1.23 million in cash and cash equivalents and \$23.54 million in marketable securities. We believe that our existing cash and cash equivalents and cash flows from our operating activities, plus funds available from the sale of our marketable securities, will be sufficient to fund our working capital and capital expenditure needs for 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 March 31, 2010, 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 March 31, 2010 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.

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 5. EXHIBITS

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

SIGNATURES

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

QUALSTAR CORPORATION

Dated: May 13, 2010

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