QUALSTAR CORP
Form 10-Q
February 12, 2009

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the Quarterly Period Ended December 31, 2008

OR

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

For the Transition Period From to

Commission file number 000-30083

QUALSTAR CORPORATION

CALIFORNIA	95-3927330
(State of incorporation)	(I.R.S. Employer Identification No.)

3990-B Heritage Oak Court, Simi Valley, CA 93063
(805) 583-7744

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports); and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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 o Accelerated filer o Non-accelerated filer ¨ Smaller reporting company þ

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

Total shares of common stock without par value outstanding at January 30, 2009 is 12,253,117.

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PART I — FINANCIAL INFORMATION

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

QUALSTAR CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 31, 2008 (Unaudited)	June 30, 2008 (Audited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,049	$ 6,744
Marketable securities, short-term	14,619	11,091
Receivables, net of allowances of $105 at December 31, 2008, and $82 at June 30, 2008	2,574	2,962
Inventories, net	6,355	6,109
Prepaid expenses and other current assets	496	467
Total current assets	29,093	27,373
Property and equipment, net	439	526
Marketable securities, long-term	10,574	14,703
Other assets	55	55
Total assets	$ 40,161	$ 42,657
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 745	$ 1,197
Accrued payroll and related liabilities	393	519
Other accrued liabilities	936	1,774
Total current liabilities	2,074	3,490
Other long term liabilities	46	46
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 December 31, 2008 and June 30, 2008	18,753	18,705
Accumulated other comprehensive income	309	108
Retained earnings	18,979	20,308
Total shareholders' equity	38,041	39,121
Total liabilities and shareholders' equity	$ 40,161	$ 42,657

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 December 31, 2008	Three Months Ended December 31, 2007	Six Months Ended December 31, 2008	Six Months Ended December 31, 2007
Net Revenues	$ 4,623	$ 6,049	$ 10,025	$ 11,381
Cost of goods sold	3,149	4,004	6,668	7,712
Gross profit	1,474	2,045	3,357	3,669
Operating expenses:				
Research and development	765	770	1,508	1,498
Sales and marketing	753	840	1,448	1,600
General and administrative	802	918	1,568	1,656
Total operating expenses	2,320	2,528	4,524	4,754
Loss from operations	(846)	(483)	(1,167)	(1,085)
Investment Income	291	424	571	837
Loss before income taxes	(555)	(59)	(596)	(248)
(Benefit) Provision for income taxes	-	-	(2)	17
Net loss	$ (555)	$ (59)	$ (594)	$ (265)
Loss per share:				
Basic and Diluted	$ (0.05)	$ (0.00)	$ (0.05)	$ (0.02)
Shares used to compute loss per share:				
Basic and Diluted	12,253	12,253	12,253	12,253
Cash dividends declared per common share	$ (0.06)	$ (0.00)	$ (0.12)	$ (0.00)

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 December 31, 2008	2007
OPERATING ACTIVITIES:		
Net loss	$ (594)	$ (265)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Share based compensation	48	60
Gain on sale of marketable securities	(63)	(2)
Depreciation and amortization	110	153
Provision for (recovery of) bad debts and returns	22	(11)
Changes in operating assets and liabilities:		
Accounts receivable	366	(59)
Inventories	(246)	664
Prepaid expenses and other assets	(29)	(83)
Prepaid income taxes	-	3
Accounts payable	(452)	300
Accrued payroll and accrued liabilities	(126)	14
Income taxes payable	(7)	-
Other accrued liabilities	(96)	(12)
Net cash (used in) provided by operating activities	(1,067)	762
INVESTING ACTIVITIES:		
Purchases of property, equipment and leasehold improvements	(23)	(90)
Proceeds from sale of marketable securities	20,356	16,874
Purchases of marketable securities	(19,491)	(14,587)
Net cash provided by investing activities	842	2,197
FINANCING ACTIVITIES:		
Cash dividends on common shares	(1,470)	-
Net cash used in financing activities	(1,470)	-
Net change in cash and cash equivalents	(1,695)	2,959
Cash and cash equivalents, beginning of period	6,744	7,697
Cash and cash equivalents, end of period	$ 5,049	$ 10,656
Supplemental cash flow disclosure:		
Income taxes paid	$ 5	$ 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, 2008
(Unaudited) (In thousands)

	Common Stock		Accumulated Other Comprehensive	Retained	
	Shares	Amount	Income	Earnings	Total
Balance at July 1, 2008	12,253	$ 18,705	$ 108	$ 20,308	$ 39,121
Share based compensation	—	48	—	—	48
Cash dividend on common shares	—	—	—	(735)	(735)
Comprehensive loss:					
Net loss	—	—	—	(594)	(594)
Change in unrealized losses on investments	—	—	201	—	201
Comprehensive Loss	—	—	—	—	(393)
Balance at December 31, 2008	12,253	$ 18,753	$ 309	$ 18,979	$ 38,041

See the accompanying notes to these interim condensed consolidated financial statements

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QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited) (In thousands, except per share data)

Note 1 – Basis of Presentation and Consolidation

Basis of Presentation

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

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

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with 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, 2008, filed with the Securities and Exchange Commission ("SEC") on September 24, 2008.

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.

Note 2 – Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

On July 1, 2008, we adopted Financial Accounting Standards Board ("FASB") Statement No. 157, Fair Value Measurements ("SFAS No. 157") for 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). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. See Note 4 – Financial Instruments.

Statement of Financial Accounting Standard ("SFAS") No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115, became effective for us on July 1, 2008. SFAS No. 159 gives us the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis with the difference between the carrying value before election of the fair value option and the fair value recorded upon election as an adjustment to beginning retained earnings. We chose not to elect the fair value option for all marketable securities outstanding as of December 31, 2008.

Recent Accounting Pronouncements Not Yet Adopted

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS 162 will become effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." We believe the adoption of SFAS 162 will not have a material impact on our financial statements.

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QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133, which requires additional disclosures about the objectives of derivative instruments and hedging activities, the method of accounting for such instruments under SFAS No. 133 and its related interpretations, and a tabular disclosure of the effects of such instruments and related hedged items on our financial position, financial performance, and cash flows. SFAS No. 161 is effective for us beginning January 1, 2009. We believe the adoption of SFAS No. 161 will not have a material impact on our financial statements.

In February 2008, the FASB issued FASB Staff Position 157-2, Effective Date of FASB Statement No. 157, which delays the effective date of SFAS No. 157 to July 1, 2009 for us, 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). We believe the adoption of the delayed items of SFAS No. 157 will not have a material impact on our financial statements.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations, which replaces SFAS No. 141. 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. SFAS No. 141R is effective for us beginning July 1, 2009 and will apply prospectively to business combinations completed on or after that date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51, which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in net income. SFAS No. 160 is effective for us beginning July 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. We believe the adoption of SFAS No. 160 will not have a material impact on our financial statements.

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

We are exposed to foreign currency and 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 29.3% of net revenues in the three months ended December 31, 2008, and 30.4% of net revenues in the three months ended December 31, 2007. Sales outside of North America represented approximately 27.2% of net revenues in the six months ended December 31, 2008, and 26.9% of net revenues in the six months ended December 31, 2007.

One customer accounted for 15.7% of the Company's consolidated revenue for the three-month period ended December 31, 2008. The customer's accounts receivable balance, net of specific allowances, totaled approximately 14.3% of net accounts receivable. No single customer accounted for more than ten percent of the Company's consolidated revenue for the three-month period ended December 31, 2007.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

One customer accounted for 12.9% of the Company's consolidated revenue for the six-month period ended December 31, 2008. The customer's accounts receivable balance, net of specific allowances, totaled approximately 14.3% of net accounts receivable. No single customer accounted for more than ten percent of the Company's consolidated revenue for the six-month period ended December 31, 2007.

Sales and costs of goods sold related to tape library products only available from one supplier totaled approximately 16.3% and 20.8% for the three months ended December 31, 2008 and 19.0% and 21.4% for the three months ended December 31, 2007, respectively, of total sales and cost of goods sold. Sales and costs of goods sold totaled approximately 15.6% and 19.3% for the six months ended December 31, 2008 and 22.0% and 24.1% for the six months ended December 31, 2007, respectively, of total sales and cost of goods sold.

Note 4 – 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.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
In thousands (except per share amounts):	2008	2007	2008	2007
Net loss (a)	$ (555)	$ (59)	$ (594)	$ (265)
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)	$ (0.05)	$ (0.00)	$ (0.05)	$ (0.02)
Diluted net loss per share (a)/(c)	$ (0.05)	$ (0.00)	$ (0.05)	$ (0.02)

Stock options are excluded for the three and six month periods ended December 31, 2008 and 2007, respectively, from the computation of diluted loss per share, as the effect would have been anti-dilutive.

Note 5 – Marketable Securities

Marketable securities consist primarily of commercial paper, U.S. government and agency securities, mortgage-backed securities and corporate bonds. In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity 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, 2008 and June 30, 2008.

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. Gain (loss) on the sale of securities for the three months ended December 31, 2008 and 2007 was $67,000 and $(1,000), respectively. Gain on the sale of securities for the six months ended December 31, 2008 and 2007 was $63,000 and $2,000, respectively. The change in net unrealized holding gain on available-for-sale securities that has been included in the other comprehensive income of shareholder's equity during the six months ended December 31, 2008 and 2007 was $201,000 and $140,000, respectively.

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QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS- (Continued)

Note 6 – Financial Instruments

We adopted SFAS No. 157 on July 1, 2008 for 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). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

SFAS No. 157 defines fair value 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.

In addition to defining fair value, SFAS No. 157 expands the disclosure requirements around fair value and establishes a fair value hierarchy for valuation inputs. The hierarchy prioritizes the 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 December 31, 2008 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. Our mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association and Federal Home Loan Mortgage Corporation.

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QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS- (Continued)

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 December 31, 2008:

(In thousands)	Level 1	Level 2	Net balance
Assets			
Cash	$ 474		$ 474
Money Market Mutual fund	4,575		4,575
Commercial paper	–		$
U.S. government and agency securities	6,096	11,656	17,752
Mortgage-backed securities	–	3,612	3,612
Corporate bonds	–	3,325	3,325
Municipal securities	–	503	503
Total	$ 11,145	$ 19,096	$ 30,241

Note 7 - 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, 2008	June 30, 2008
Raw materials	$ 6,271	$ 6,053
Finished goods	712	785
Subtotal	6,983	6,838
Less: Inventory reserve	(628)	(729)
	$ 6,355	$ 6,109

Note 8 – 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):

	December 31, 2008	June 30, 2008
Beginning balance	$ 181	$ 174
Cost of warranty claims	(15)	(66)
Accruals for product warranties	13	72
Ending balance	$ 179	$ 181

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QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS- (Continued)

Note 9 – Comprehensive Loss

For the six months ended December 31, 2008 and 2007, comprehensive loss amounted to approximately $393,000 and $125,000, 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 10 – Legal Proceedings

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

Note 11 – Income Taxes

We recorded a benefit for income taxes of $2,000 for the six months ended December 31, 2008. 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 quarter 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.

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

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 managed and monitored performance for the six months ended December 31, 2008 and 2007. 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. Allocations for internal resources were made for the six months ended December 31, 2008 and 2007.

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.

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QUALSTAR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS- (Continued)

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 December 31,		Six Months Ended December 31,	
	2008	2007	2008	2007
Revenue				
Tape Libraries:				
Product	2,520	4,379	5,596	8,331
Service	625	624	1,337	1,280
Total Tape Libraries	3,145	5,003	6,933	9,611
Power Supplies	1,478	1,046	3,091	1,770
Consolidated Revenue	4,623	6,049	10,024	11,381

	Three Months Ended December 31,		Six Months Ended December 31,	
	2008	2007	2008	2007
Income (Loss) before Taxes				
Tape Libraries	(620)	(220)	(784)	(308)
Power Supplies	65	161	190	60
Consolidated Loss before Taxes	(555)	(59)	(596)	(248)

	December 31, 2008	June 30, 2008
Total Assets		
Tape Libraries	$ 38,100	$ 41,257
Power Supplies	2,061	1,400
Consolidated Assets	$ 40,161	$ 42,657

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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, 2008 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, 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 a complete 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 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.

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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 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) in accordance with SFAS No. 157, "Fair Value Measurements." 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.

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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 11 – Income Taxes to the consolidated condensed 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.

RESULTS OF OPERATIONS

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2008	2007	2008	2007
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	68.1	66.2	66.5	67.8
Gross profit	31.9	33.8	33.5	32.2
Operating expenses:				
Research and development	16.5	12.7	15.0	13.2
Sales and marketing	16.3	13.9	14.4	14.1
General and administrative	17.3	15.2	15.6	14.6
Total operating expenses	50.1	41.8	45.0	41.9
Loss from operations	(18.2)	(8.0)	(11.5)	(9.7)
Investment income	6.3	7.0	5.7	7.4
Loss before income taxes	(11.9)	(1.0)	(5.8)	(2.3)

Provision for income taxes	0.0	0.0	0.0	0.1
Net loss	(11.9)%	(1.0)%	(5.8)%	(2.4)%

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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 December 31,		Six Months Ended December 31,	
	2008	2007	2008	2007
Tape Library revenues:				
TLS	25.8%	33.1%	24.6%	32.9%
RLS	5.1	10.6	7.4	10.8
XLS	4.8	8.8	6.6	7.7
	35.7	52.5	38.6	51.4
Other library revenues:				
Service	13.5	10.3	13.3	11.3
Media	13.9	15.1	12.8	16.1
Upgrades, spares	4.9	4.8	4.5	5.7
	32.3	30.2	30.6	33.1
Total Library revenues	68.0	82.7	69.2	84.4
Power Supply revenues	32.0	17.3	30.8	15.6
	100.0%	100.0%	100.0%	100.0%

Three Months Ended December 31, 2008 Compared to Three Months Ended December 31, 2007

Net Revenue. Net revenues decreased to $4.6 million for the three months ended December 31, 2008 from $6.0 million for the three months ended December 31, 2007, a decrease of $1.4 million, or 23.6%. One customer accounted for 15.7% of the Company's consolidated revenue for the three-month period ended December 31, 2008. The customer's accounts receivable balance, net of specific allowances, totaled approximately 14.3% of net accounts receivable. No single customer accounted for more than ten percent of the Company's consolidated revenue for the three-month period ended December 31, 2007.

Segment Revenue

Tape Libraries – Net tape library revenues decreased to $3.1 million for the three months ended December 31, 2008 from $5.0 million for the three months ended December 31, 2007, a decrease of $1.9 million, or 37.2%. The decrease in revenues is attributed to a $1.5 million decline in revenues from our TLS, RLS and XLS tape library product lines and a $0.3 million decline in revenues from sales of tape media and a $0.1 million decline in revenues from sales of upgrades and spares.

One customer accounted for 13.5% of tape library revenues for the three-month period ended December 31, 2008. No single customer accounted for more than ten percent of tape library revenues for the three-month period ended December 31, 2007.

Power Supplies – Net revenues from power supplies increased to $1.5 million for the three months ended December 31, 2008 from $1.0 million for the three months ended December 31, 2007, an increase of $.5 million, or 41.3%. The increase in revenues is attributed to the launch of a new power supply model and sales to a new original equipment manufacturer customer under a nine-month contract. Two customers accounted for 49.0% and 14.4%, respectively, or

63.4% in the aggregate, of power supply sales for the three months ended December 31, 2008. Two customers 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.

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 $1.5 million, or 31.9% of net revenues, for the three months ended December 31, 2008 from $2.0 million, or 33.8% of net revenues, for the three months ended December 31, 2007. The decrease in gross profits in the current quarter, both in absolute dollars and as a percentage of net revenues, is primarily due to a change in product mix, partially offset by efficiencies achieved in labor and overhead.

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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 remained comparable at $0.8 million for the three months ended December 31, 2008 and $0.8 million for the three months ended December 31, 2007.

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 $0.7 million for the three months ended December 31, 2008 from $0.8 million for the three months ended December 31, 2007. The decrease of $0.1 million, or 10.4%, is primarily due to a decrease in commission expense correlated to lower revenues and lower advertising and promotion expenses partially offset by an increase in 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 $0.8 million for the three months ended December 31, 2008 from $0.9 million for the three months ended December 31, 2007. The decrease of $0.1 million, or 12.6%, is primarily due to a decrease in accounting and audit related expenses including fees associated with the Sarbanes Oxley compliance efforts that were completed in fiscal 2008, partially offset by an increase in compensation related expenses.

Investment Income. Investment income decreased to $0.3 million for the three months ended December 31, 2008 from $0.4 million for the three months ended December 31, 2007. The decrease of $0.1 million, or 31.4% is primarily due to the lower interest rate environment in the recent quarter and partially due to having approximately $3.8 million less cash, cash equivalents and marketable securities in the quarter ended December 31, 2008 compared to the prior year quarter.

Provision for Income Taxes. We did not record a benefit for income taxes for the three months ended December 31, 2008 or for the three months ended December 31, 2007.

Six Months Ended December 31, 2008 Compared to Six Months Ended December 31, 2007

Net Revenue. Net revenues decreased to $10.0 million for the six months ended December 31, 2008 from $11.4 million for the three months ended December 31, 2007, a decrease of $1.4 million, or 11.9%. One customer accounted for 12.9% of the Company's consolidated revenue for the six-month period ended December 31, 2008. The customer's accounts receivable balance, net of specific allowances, totaled approximately 14.3% of net accounts receivable. No single customer accounted for more than ten percent of the Company's consolidated revenue for the six-month period ended December 31, 2007.

Segment Revenue

Tape Libraries – Net tape library revenues decreased to $6.9 million for the six months ended December 31, 2008 from $9.6 million for the six months ended December 31, 2007, a decrease of $2.7million, or 27.9%. The decrease in revenues is attributed to a $2.0 million decline in revenues from our TLS, RLS and XLS tape library product lines, a $0.5 million decline in revenues from sales of tape media, and a $0.2 million decline in sales of upgrades and spares.

Two customers accounted for 12.3% and 10.6%, respectively, or 22.9% in the aggregate, of tape library revenues for the six-month period ended December 31, 2008. No single customer accounted for more than ten percent of tape library revenues for the six-month period ended December 31, 2007.

Power Supplies – Net revenues from power supplies increased to $3.1 million for the six months ended December 31, 2008 from $1.8 million for the six months ended December 31, 2007, an increase of $1.3 million, or 74.6%. The increase in revenues is attributed to the launch of a new power supply model and sales to a new original equipment manufacturer customer under a nine-month contract. Two customers accounted for 42.0% and 12.8%, respectively, or 54.8% in the aggregate, of power supply sales for the six months ended December 31, 2008. Two customers 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.

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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 for the six months ended December 31, 2008 from $3.7 million for the six months ended December 31, 2007. However, gross profit as a percentage of net revenues increased to 33.5% for the six months ended December 31, 2008 compared to 32.2% for the six months ended December 31, 2007. The increase in gross profits as a percentage of net revenue for the six months ended December 31, 2008 is primarily due to efficiencies achieved in labor and overhead, partially offset by a change in product mix.

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 remained comparable at $1.5 million for the six months ended December 31, 2008 and $1.5 million for the six months ended December 31, 2007.

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 $1.4 million for the six months ended December 31, 2008 from $1.6 million for the six months ended December 31, 2007. The decrease of $0.2 million, or 9.5%, is primarily due to a decrease in commission expense correlating to lower revenues and lower advertising and promotion expenses partially offset by an increase in 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 $1.6 million for the six months ended December 31, 2008 from $1.7 million for the six months ended December 31, 2007. The decrease of $0.1 million, or 5.3%, is primarily due to a decrease in accounting and audit related expenses including fees associated with the Sarbanes Oxley compliance efforts that were completed in fiscal 2008, partially offset by an increase in compensation related expenses.

Investment Income. Investment income decreased to $0.6 million for the six months ended December 31, 2008 from $0.8 million for the six months ended December 31, 2007. The decrease of $0.2 million, or 31.8% is primarily due to the lower interest rate environment in the recent quarters and partially due to having approximately $3.8 million less cash, cash equivalents and marketable securities in the six month period ended December 31, 2008 compared to the prior year six month period.

Provision for Income Taxes. We recorded a benefit for income taxes of $2,000 for the six months ended December 31, 2008. We recorded a provision for income taxes of $17,000 for the six months ended December 31, 2007 relating to state income taxes paid 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.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used by operating activities was $1.1 million in the six months ended December 31, 2008, 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. Net cash provided by operating activities was $762,000 in the six months ended December 31, 2007, primarily attributed to an decrease in inventories and an increase in accounts payable, partially offset by an increase in prepaid expenses and other assets, and the net loss from operations.

Cash provided by investing activities was $842,000 in the six months ended December 31, 2008, primarily attributed to the sale of marketable securities, partially offset by the purchase of marketable securities. 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 financing activities was $1.5 million in the six months ended December 31, 2008, attributed to the payment of cash dividends of $0.06 per share that we declared on June 23, 2008 and November 11, 2008 and paid on September 5, 2008 and December 4, 2008, respectively, on shares of our common stock. Cash was not used in or provided by financing activities during the six months ended December 31, 2007.

As of December 31, 2008, we had $5.0 million in cash and cash equivalents and $25.2 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.

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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, 2008, 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 December 31, 2008 of Qualstar's fiscal year ending June 30, 2009, that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

ITEM 6. EXHIBITS

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

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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 12, 2009	By:	/s/ WILLIAM J. GERVAIS William J. Gervais Chief Executive Officer and President (Principal Executive Officer)

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