SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

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

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

☐ **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

Securities registered pursuant to Section 12(b) of the Act:
NONE

Securities registered pursuant to Section 12(g) of the Act:
COMMON STOCK

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☑

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☑

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

As of December 31, 2004, the aggregate market value of the common equity held by non-affiliates of the registrant was approximately $32,071,000.

The total shares of common stock without par value outstanding at September 16, 2005 is 12,253,117.

DOCUMENTS INCORPORATED BY REFERENCE

Items 10, 11, 12, 13 and 14 of Part III of this Form 10-K are incorporated by reference from the registrant's definitive proxy statement for its annual meeting of shareholders, which will be filed with the Commission on or before October 28, 2005.

To Our Shareholders:

Our fiscal year ended June 30, 2005 finished on a positive note, with fourth quarter revenues reaching a high for the year of $6.7 million. Since then we have narrowed our losses and are currently running the business at close to breakeven levels.

Revenues in fiscal 2005 totaled $25.1 million, compared to $31.5 million in fiscal 2004. We faced a somewhat difficult comparison in fiscal 2005, as the prior year's sales benefited from a large, non-recurring library order worth approximately $2.5 million and from sales of nine-track tape drives before we discontinued that product line.

During fiscal 2005 we generated positive cash flow of $204,000 from operating activities and took advantage of our strong cash position to buy back 359,000 shares of Qualstar's common stock as part of our stock repurchase program. We ended fiscal 2005 with no debt on our balance sheet and $34.1 million, or $2.75 per diluted share, in cash, cash equivalents and marketable securities.

Our current suite of tape library products is highly diversified with approximately 40 different active models available for shipment to customers. All of these models provide significant storage and back-up capacity and efficiency within a small physical footprint. While we support multiple tape formats and offer a wide range of products to the marketplace, which is a key differentiator that keeps our brand attractive to resellers, our recent efforts have been appropriately focused on LTO-based libraries, given the interest they are generating within our customer base. Our design philosophy, manufacturing approach and flexibility, permits us to respond rapidly to such changes in customer preference.

Recently, we announced our support for the new Ulysses™ disk-as-tape cartridge from Imation, which will bring a completely new dimension to our RLS tape libraries. Because the disk cartridge is installed in the shell of an LTO tape cartridge, it can be easily handled by our library robotics and allows tape and disk to be intermixed to optimize the media for the application.

As you're aware, we've been working to transition Qualstar toward the higher end of the product spectrum, where opportunities for a company of our size are more plentiful and where margins are higher. Currently, the development of our enterprise class library, the XLS, is progressing well. We're continuing with 24 hour per day product qualification testing to increase our confidence in the design and verify the product's reliability. We anticipate shipping our first production units in the fourth quarter of fiscal 2006, and will likely increase marketing spending over the next several quarters as we prepare for the launch. In addition to our base model, which can house up to 680 tapes and is easily expandable to incorporate up to 6,000 tapes, we've also recently added a second, smaller XLS model to the product family in response to feedback from some of our key resellers. This newer unit, which is now in pilot production, can house up to 460 tapes, and is also expandable. Both XLS products utilize a common firmware set and share a high degree of common parts, which has been our approach to tape automation designs. We believe the market for our XLS product line will provide an opportunity to return the Company to a revenue growth model. The XLS, which provides much higher volumetric efficiency than competitive offerings, will improve upon the efficiency and cost effectiveness of libraries in this class.

Our N2Power business is continuing its steady growth and performed extremely well in fiscal 2005. Power supply revenues were $1.3 million in fiscal 2005, an approximate 128% increase from the prior year. Each quarter, N2Power becomes a larger contributor to overall Company sales and we are encouraged by our prospects for continued growth in this segment. As the result of applications and products that demand smaller and more efficient power supplies, market interest is building. We've established solid relationships with several important OEMs and contract manufacturers who are now utilizing N2Power products. Qualstar's TLS and RLS tape libraries also incorporate our N2Power power supplies. Our current power supply product line is comprised of the original 125-watt series, a newer 160-watt series and our newest 250-watt line, which began shipping in the first quarter of fiscal 2006 and has been well received by customers thus far.

Our core tape library business is stable, we're making steady progress on the XLS product, and our N2Power division is successfully meeting the growing demand for high efficiency power supplies. This year we'll be working toward bringing XLS to market and building our power supply business further.

It is with much sadness that I inform you of the passing of Jose Miyar, a member of our Board of Directors and advisor to the Company since its inception, who unexpectedly died in October 2005. His personal insight and dedication to Qualstar will be greatly missed by all.

I would like to welcome Stanley Corker to our Board. Stan's career spans 20 years of tape technology and data storage experience, which will be very important to us, especially as we work toward launching the XLS.

Thank you to the entire Qualstar team for your hard work and dedication, and to all of our shareholders for your ongoing support.

Sincerely,

February 15, 2006

William J. Gervais
President and Chief Executive Officer

Qualstar Corporation

FORM 10-K

For The Fiscal Year Ended June 30, 2005

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains 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. 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 "ITEM 1 — Business," including the section therein entitled "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," "will," "expects," "intends," "estimates," "anticipates," "plans," "seeks," or "continues," or the negative thereof or variations thereon or similar terminology. Forward looking statements also include the assumptions underlying or relating to any such statements. Forward looking statements contained within this document represent a good-faith assessment of Qualstar's future performance for which management believes there is a reasonable basis. Qualstar disclaims any obligation to update the forward looking statements contained herein, except as may be required by law.

PART I

Item 1. *Business*

Introduction

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. Our products are compatible with commonly used operating systems, including UNIX, Windows, and Linux. Our tape libraries are also compatible with a wide range of storage management software packages, such as those supplied by Computer Associates, EMC/Legato, Tivoli, Symantec/Veritas, CommVault and BakBone Software. We offer tape libraries for multiple tape drive technologies, including LTO, AIT, Super AIT, and SuperDLT.

We sell our tape libraries worldwide, primarily to value added resellers, system integrators and original equipment manufacturers. These customers typically integrate our tape libraries with software from third party vendors and related hardware such as servers and network components to provide storage solutions, which are then sold to end users. We configure our libraries based on each customer's individual requirements, with a normal delivery time of one to three working days. This rapid fulfillment of customer orders allows our resellers to minimize their inventory levels and allows us to compete effectively with distribution channels used by our competitors.

Qualstar was incorporated in California in 1984. Our initial products were IBM compatible 9-track reel-to-reel tape drives. In 1995, we entered the tape automation market with a series of tape libraries incorporating 8mm tape drives. Since that time, we have introduced a succession of tape library models designed to work with the leading automation-capable tape drive technologies. Automated tape libraries and related products, such as tape drives and tape media, represented approximately 75.1% of revenues for fiscal 2005, approximately 81.4% of revenues for fiscal 2004, and approximately 79.8% of revenues for fiscal 2003. Sales of power supplies, services and other products accounted for the balance of our revenues.

In July 2002, we purchased the assets of N2Power, Incorporated, a supplier of ultra small high efficiency open-frame switching power supplies. Power supplies provided by N2Power are utilized within our tape library products as well as sold to original equipment manufacturers for incorporation into their products. N2Power products are sold under the N2Power brand name as well as under a private label brand name through independent sales representatives and distributors. Revenues from N2Power products totaled 5.0% of total revenues for fiscal 2005 and 1.8% of total revenues for fiscal 2004.

Industry Background

Storing, managing and protecting data has become critical to the operation of many enterprises and governments as the world economy becomes increasingly information dependent. The data storage industry is growing in response to the increase in the amount of data that is generated and that must be preserved. The amount of data has been increasing due to the growth in the number of computers, the number, size and complexity of computer networks and software applications, and the emergence of new applications such as image processing, e-commerce, internet services, medical image storage, video and motion picture image storage, and other multi-media applications. In addition, businesses continue to generate increasing amounts of traditional business information with respect to their products, customers and financial data. This increase in the amount of data that is generated stimulates increases in the demand for data storage and the management of this data.

Factors Driving Growth in Data Storage

- *Increased demand from Internet and e-commerce businesses.* The growth in the Internet and e-commerce has created businesses that depend on the creation, access to and archival storage of data. We believe this demand will continue to grow as individuals and businesses increase their reliance on the Internet for communications, commerce and data retrieval.
- *Growth in new types of data.* New types of data are also fueling the growth in data storage. For example, graphics, audio and MP3, video, medical and security images, and multi-media uses such as video on demand, require far greater storage capacity than text and financial data.
- *Recognition of the critical importance of data.* Corporate databases contain useful information about customer records, order patterns and other factors that can be analyzed and transformed into a valuable asset and a competitive advantage. The ability to efficiently store, manage and protect this information is important to the value and success of many businesses. The usefulness of past and present data is further enhanced by new sophisticated data mining software applications that can access and analyze large databases.
- *Growing awareness of the need for disaster protection.* Companies are recognizing that without their data they may not survive. Natural disasters, as well as overt and covert actions targeted at individual companies, classes of users or whole countries, can destroy data and entire data centers, threatening a company's very existence. Systematic replication and secure off-site storage of corporate data is recognized as the best defense against catastrophic data loss. Tape libraries are a key technology in most corporate data disaster protection plans.
- *Compliance with new regulatory requirements for records retention.* Many businesses now have to deal with new regulatory requirements from various governmental agencies that require businesses to retain data for longer periods of time. The regulations that have received the most visibility include HIPAA requirements covering medical records; Sarbanes-Oxley, which addresses corporate governance; and Rule 17a under the Securities Exchange Act of 1934, regarding recordkeeping requirements for the securities industry. These regulations and others are projected to increase demand for long-term storage capacity over the next few years.
- *Growth in network computing applications and data.* The use of computer networks has shifted critical information and applications to network servers to allow more people to gain access to stored data as well as to create new data. As the speed of network computing has increased, numerous new applications have become feasible such as computer fax and e-mail, all of which generate progressively more data. Organizations are increasingly aware of the need to protect this data, as networks become a mission-critical element of many operations.
- *Decrease in the costs of storing data.* The costs of data storage have decreased with advances in technology and improved manufacturing processes. We expect these costs to continue to decrease. The decrease in the cost of data storage encourages the storage of more data and makes it more cost effective to add storage capacity than to remove old data, which in the past may have been purged periodically.

Advances in Storage Management Technologies

The growth in data is contributing to an evolution in traditional storage solutions. New technologies are designed to provide high-speed connectivity for data-intensive applications across multiple operating systems, including UNIX, Windows, and Linux. These new methods of storage and data management technologies include the following:

- *Fibre Channel.* Fibre Channel is an interface technology based on industry standards for the connection of storage devices to networks. Interface is the term used to describe the electronics, cabling and software used to facilitate communications between devices. With Fibre Channel, users are better able to share stored information with other storage devices and servers over longer distances, with data transfer speeds significantly faster than the most common interface technology in use today, thereby increasing the importance of storage area networks.
- *Storage Area Networks.* Storage Area Network, or SAN, architecture applies the inherent benefits of a networked approach to data storage applications, which allows data to move efficiently and reliably between multiple storage devices and servers. The benefits of SAN architecture also include increasing the expandability of existing storage solutions and providing a higher level of connectivity than exists with traditional technologies. Additionally, SANs are able to provide these benefits across multiple operating systems.
- *Advanced storage management software.* This software automatically migrates infrequently accessed data to the lower cost storage medium such as a tape library. A user's request for this data at some later date will recall the data automatically from the tape library. This process reduces the overall storage cost by using the least expensive storage medium to store data that is not expected to be needed on a frequent basis. Advances in storage management software have increased the ability of businesses to more cost-effectively store, manage and retrieve data, which in turn allows businesses to operate more efficiently.
- *Network Attached Storage.* Current storage devices are dependent on a file server for all commands and control. Network attached storage devices give storage devices file server functionality, which allow users to plug a storage device directly into a network without requiring a separate file server. This allows users to maintain, or even enhance, system performance while saving on both time and cost.

Types of Data Storage

Current non-volatile storage solutions are based primarily on two technologies: magnetic disk and magnetic tape. These technologies represent a compromise among a variety of competing factors including capacity, cost, speed, portability and data reliability. Magnetic tapes are removable, which allows them to be transported easily to an off-site location for security or protection from physical harm. Magnetic disks provide quicker access to stored data and generally are used when speed is important. Less frequently used data is often migrated from magnetic disks to tape storage. Tape libraries provide a near-online solution, where less frequently used data files are stored on tape at substantially lower cost compared to disk while still providing automated access.

Tape Libraries and Applications

Tape libraries automate the tape loading process, eliminate errors induced by human operators, and enhance security compared to tapes that must be retrieved and loaded manually. Tape libraries can also be operated from remote locations around the clock, thus, eliminating the need for an operator. Automated tape libraries are a key component in a company's overall storage solution and data protection strategy.

Tape drives and tape media are two key components of tape libraries. The costs of tape drives and tape media have declined with advances in technology, and we expect this trend to continue. As prices decline, new applications for automated storage become justified, further increasing the number of applications that can benefit from the use of tape libraries. We believe that continued technological improvements in tape drives and tape media will further reduce overall storage costs in the future.

Current and emerging applications for tape libraries include:

- *Automated backup.* Backup is the creation of a duplicate copy of current data for the purpose of recovering the data in the event the original is lost or damaged. An automated tape library, in conjunction with storage management software, can backup network data at any time without human intervention. A library with multiple tape drives can backup data using all of its drives simultaneously, thus significantly speeding up the recording process. Backup tapes can be removed from the library and stored in an off-site location for protection against a loss of the primary site.

- *Archiving.* Archiving is the storage of data for historical purposes. When information is stored on tape, automated tape libraries, under application control, can catalog tapes for future retrieval and prevent unauthorized removal or corruption of data by using password or key lock protection. Archival tapes provide a historic record for use in fraud detection, audit, legal and other processes. Tape libraries are also used for archiving due to benefits offered by the tape medium, such as long-term data integrity, resistance to environmental contamination, ease of relocation, low cost, and the availability of "Write Once Read Many" or WORM tapes.

- *Digital video.* Digital recording of camera images for surveillance and security purposes is an alternative to traditional analog VHS recording in installations such as airports, retail stores, government facilities and gaming operations. This is an important market opportunity because tape libraries eliminate the need for operators to load, unload, store and retrieve the large number of tapes created in these facilities. Library based systems index, store and play back the video images on demand, significantly reducing the retrieval time and cost of operation when compared to VHS recording and playback devices. Digital recording technology provides higher resolution than analog VHS recording technology.

- *Image management.* Storage-intensive applications such as satellite mapping and medical image management systems are turning to tape libraries because of the cost advantage over traditional storage methods. X-ray images or MRI results, for instance, must frequently be kept on file for years. Storing a digitized image in a tape library costs considerably less than storing a film copy, and can be retrieved years later with the click of a mouse.

Distribution of Tape Library Products

The requirements for storage solutions vary depending on the size of an enterprise, the type of data generated and the amount of data to be stored. With the increased dependence on stored data, most organizations, regardless of their size, have a heightened need for storage solutions that integrate devices such as tape drives, tape libraries and storage management software. Those organizations with sufficient in-house information technology resources can rely on their internal infrastructure and expertise to design, purchase and implement their own storage solutions. These organizations may elect to purchase equipment from distributors or directly from the original equipment manufacturers. Many organizations, however, do not have sufficient in-house resources but have the same need for data storage solutions. These organizations often look to value added resellers to design, supply and install their storage solutions.

Value added resellers develop and install storage solutions for enterprises that face complex storage needs but lack the in-house capability of designing and implementing the proper solution or have chosen to outsource these functions. Typically, the value added reseller will select among a variety of different hardware technologies and software options, as well as provide installation and other services, to deliver a complete storage solution for the end user. Value added resellers require rapid turnaround of orders, custom configuration of tape libraries, drop shipment to their customer's site, compatibility with multiple tape formats and software, and marketing and technical support.

Original equipment manufacturers generally resell products made by others under their own brand name and typically assume responsibility for product sales, service and support. Original equipment manufacturers enable manufacturers, such as Qualstar, to reach end users not served by other channels and to serve select vertical markets where specific original equipment manufacturers have exceptional strength. Original equipment manufacturers require special services such as product configuration control, extensive qualification testing, custom colors and private labeling.

Our Solutions

We offer storage solutions that respond to the growing data management challenges facing businesses today, while addressing the unique needs of value added resellers and original equipment manufacturers.

We believe that high reliability is important to the end users of our products due to the critical nature of the data that is being stored, shorter time periods available for the back-up operations, and the operation of backup systems during hours when personnel may not be available to respond to problems. To address these concerns, we emphasize quality and reliability in the design, manufacturing and testing of our products which reduces the potential for product failures and results in products that require little maintenance.

The technology utilized in automated tape libraries is continuously evolving due to advances in data recording methods, component cost reductions, advances in semiconductor and microprocessor technologies, and a general trend toward miniaturization in the electronics industry. This changing technology requires that we continuously develop and market new products to prevent our product lines from becoming obsolete.

Our tape libraries are compatible with over forty-five (45) third-party storage management software packages, including those supplied by Computer Associates, EMC/Legato, Tivoli, Symantec/Veritas, CommVault and BakBone Software. Storage management software enables network administrators to allocate the use of storage technologies among user groups or tasks, to manage data from a central location, and to retrieve, transfer and backup data between multiple workstations. We believe that storage management software is a crucial component of any automated storage installation, and lack of compatibility is a significant barrier to entry for new tape library competitors. To ensure compatibility, our engineers work with independent software vendors during the product development cycles. We do not have contracts with any independent software vendors, nor do we need access to their software code to design our products. We maintain relationships with them by supplying tape libraries so they can qualify their software to work with our tape libraries and by evaluating their software for compatibility with our tape libraries. We also support our relationships with them by keeping them informed about current and anticipated changes to our products and by referring business to them when value added resellers or end users inquire about storage management software sources.

Strategy

Our goals are to enhance our position as a supplier of automated tape libraries and to maintain or increase our market share in each of the tape formats in which we compete. To achieve these goals, we intend to:

- *Offer libraries for multiple tape drive technologies.* We offer tape libraries for a range of tape drive technologies, including LTO, AIT, Super AIT, and SuperDLT. By offering products based on multiple tape drive technologies, we reduce our dependence on the success of any single technology and can offer products that target the specific preferences of resellers and original equipment manufacturers and their end user customers.

- *Focus on value added reseller channels.* We sell our products primarily through selected value added resellers who have a strong market presence, have demonstrated the ability to work directly with end users, and who maintain relationships with major vendors of storage management software. Because we market our products primarily through this channel, we have implemented a variety of programs to support and enhance our relationships with our reseller partners. These programs are designed to benefit the reseller and increase the likelihood of selling our products. We intend to maintain our marketing presence in support of this channel. We conduct business with our value added resellers on an individual purchase order basis and no long-term purchase commitments are involved.

- *Maintain and strengthen original equipment manufacturer relationships.* We sell our products to several companies under private label or original equipment manufacturer relationships. Original equipment manufacturer sales enable us to reach some end users not served by our value added resellers. The same product characteristics that make our tape libraries attractive to value added resellers also are important to original equipment manufacturers. We conduct business with our original equipment manufacturer customers on an individual purchase order basis and no long-term purchase commitments are involved.

- *Develop libraries for new tape technologies.* The tape drive industry is continuously advancing the state of technology. We will continue to design new libraries for those technologies that appear promising and that meet our standards for capacity, quality and reliability.

- *Maintain our rate of innovation.* We plan to maintain our high level of investment in research and development to exploit emerging technologies and product opportunities. We intend to continue the expansion of our product lines to incorporate higher capacities and new technologies.

We believe that our experience, efficiency and strict control over the development and manufacture of new products are key factors in the successful execution of our strategy. We design our tape libraries with a high percentage of common parts, use quality components and minimize the number of moving parts. We utilize proprietary techniques in the design, production and testing of our libraries in order to simplify the manufacturing process and reduce our costs. We manufacture all of our products at a single facility and we control our inventory closely to provide rapid delivery to our customers. These steps allow us to design and bring to market new products rapidly in response to changing technology.

Products

Tape Libraries

We offer a number of tape library families, each capable of incorporating one or more tape drive technologies, as summarized in the following table:

Product Family	Tape Drive Technology	Range of Tape Cartridges	Maximum Capacity in Terabytes(1)
TLS-4000	Sony AIT	12 to 600	120.0
TLS-5000	Sony SAIT	33 to 264	132.0
TLS-6000	Quantum SDLT	10 to 240	72.0
TLS-8000	LTO	11 to 264	105.6
RLS-4000	Sony AIT	22 to 70	14.0
RLS-5000	Sony SAIT	16 to 44	22.0
RLS-6000	Quantum SDLT	27	8.1
RLS-8000	LTO	12 to 44	17.6

(1) A Terabyte is one million megabytes, or one thousand gigabytes. The table shows native capacity and excludes gains from data compression, which can increase capacity by more than 100%.

Our tape library families include a number of models that differ in storage capacity, price and features. Our libraries are installed in network computing environments ranging from small departmental networks to enterprise-wide networks supporting hundreds of users. We believe that selling products for multiple tape drive technologies insulates us somewhat from the dynamics of the marketplace as various tape standards compete for market share. This helps our products appeal to the broadest possible range of end user market segments. This wide range of products makes us a one-stop supplier for our value added reseller and original equipment manufacturer customers, enabling them to meet most end user requirements for a specific tape format. Our wide range of products for competing tape drive technologies also helps to insulate us from the occasional supply shortages from tape drive or tape media manufacturers.

Tape libraries generally contain two or more tape drives and from several to thousands of tapes. We concentrate our product offerings in the mid-range of 10 to 600 tapes. We design our tape libraries for continuous, unattended operation. Multiple tape drives allow simultaneous access to different data files by different users on the network, and increase the rate at which data can move on to, out of, or within the network. A library with multiple tape drives can back up data using all drives simultaneously, significantly speeding up the recording process. In some of our libraries, tape cartridges are stored in removable magazines, allowing for easy bulk removal of the tapes. Our libraries also offer features such as barcode readers to scan cartridge labels and an input/output port for importing and exporting tapes under system control. Several of our library models are expandable in the field by increasing the number of tape storage positions. This feature provides the end user with the ability to increase data capacity as storage needs grow.

We continue to develop and release new libraries to expand our product offerings to meet the changing demands of the marketplace. In addition, we continue to enhance and improve our existing products to maintain our competitive position.

Some of our tape libraries incorporate a number of specialized features that we believe improve reliability, serviceability and performance, including:

- *Rapid tape drive replacement.* We design our libraries so that a tape drive can be replaced quickly without special tools. This feature minimizes the off-line time required when a tape drive must be replaced, and frequently avoids the high cost and delays of a service call.

- *Fibre Channel connectivity.* We offer a Fibre Channel option on many of our models for connection to Storage Area Networks and other high performance applications.

- *Closed-loop servo control.* Our tape libraries use digital closed-loop servo control for robotic motion to provide precise tape handling. This yields motion that is smooth, repeatable and highly reliable.

- *Brushless motors.* Motors are a key component in any robotic system. We use only brushless electric motors in our tape libraries. Brushless motors provide longer life and less electrical noise compared to conventional brush-type motors. We build many of our own motors in order to obtain optimum performance and reliability.

- *Variable Input/Output Port.* Our VIOP feature allows users to select the number of cartridge slots to be dedicated to bulk import or export of media to or from the library.

- *Remote management.* Many larger companies with global back-up solutions or disaster management programs require tape libraries that can be put off-site in various regions, but that must be administered from a single location. With Q-Link, our remote library manager, customers can put libraries anywhere in the world and manage them from a single administrative hub using a standard web browser.

Our flagship product line, the TLS Series, is specifically designed to be placed on the floor or on a tabletop, without the need for a special equipment rack. If requested, we provide our customers with an adapter kit for rack mounting some models. Other manufacturers design libraries primarily for rack mounting, and supply an adapter for tabletop use.

Our RLS Series of tape libraries are designed to fit efficiently in equipment racks and provide back-up capacity in only five standard units, or a total of 8.75 inches of rack space. In addition, some models in the RLS series were designed to support dual-redundant power supplies and hot-swappable tape drives.

Other Products

In addition to our tape libraries, we sell ancillary products such as tape media, tape magazines, cables, bar code labels and adapters for rack mounting.

In July 2002, we purchased the assets and intellectual property of N2Power, Incorporated, a privately held company located in Newbury Park, California. Our N2Power division designs, manufactures, and sells ultra small high-efficiency open-frame switching power supplies based on its patented technology. N2Power products are used in our tape libraries as well as sold to original equipment manufacturers and a private label distributor.

Sales and Marketing

Sales

We sell our tape library products primarily through value added resellers. Our sales force will initiate contact with value added resellers who are candidates to sell our tape libraries. We strive to develop relationships with resellers who have expertise in storage management applications, established relationships with end users and the experience to understand and satisfy their customers' needs.

We believe that by selling directly to value added resellers, we have an advantage over competitors who will often sell directly to end users, thereby competing with their resellers. Some of the advantages of our strategy include the following:

- *Higher profit margins.* Focusing on this channel, we achieve economies that result in higher profit margins to be shared by both the reseller and us.

- *Custom configurations.* We offer custom configurations of our products, such as special paint, private branding and non-standard options, on very short notice.

- *Channel conflicts avoided.* We refer substantially all end user inquiries to our reseller partners. Frequently, our sales force will make end user visits with resellers to help close a pending sale.

- *Credit.* We extend credit terms to resellers who meet our credit requirements.

- *Rapid delivery.* We generally ship a product within one to three working days of confirming an order, rivaling the delivery time of many distributors.

Although we sell our tape libraries primarily to value added resellers, we believe that original equipment manufacturers are an important element of our business. The sales cycle for original equipment manufacturers generally encompasses six months to one year and may involve extensive product and system qualification testing, evaluation, integration and verification. Original equipment manufacturers typically assume responsibility for product sales, service and support.

Our international sales are currently directed from our corporate offices in Simi Valley, California. European sales are coordinated through our European sales office in the United Kingdom. All of our international sales are denominated in U.S. dollars. Revenues from customers outside of North America were approximately $6.9 million, or 27.3% of revenues in fiscal 2005, approximately $10.2 million or 32.4% of revenues in fiscal 2004, and approximately $9.9 million or 29.4% of revenues in fiscal 2003.

Our sales are spread across a broad customer base. For the year ended June 30, 2005, no single customer accounted for more than 10% of our revenue.

Marketing

We support our sales efforts with a broad array of marketing programs designed to generate brand awareness, attract and retain qualified value added resellers and inform end users about the advantages of our products. We provide our resellers with a full range of marketing materials, including product specifications, sales literature, software connectivity information and product application notes.

We train our resellers to sell our products and to answer customers' questions. We advertise in key publications and participate in trade shows. We display our products under the Qualstar brand name at some trade shows and participate in other trade shows in partnership with our principal suppliers and resellers. We support our marketing and customer support with a website that features comprehensive marketing and product information.

We conduct sales and technical training classes for our resellers. We also conduct various promotional activities for resellers and end users, including product-specific rebates and co-operative advertising.

Customer Service and Technical Support

We believe that strong customer service and technical support is an essential aspect of our business. Our customer service and technical support efforts consist of the following components:

- *Technical support.* Our technical support personnel are available twenty-four hours per day, Monday through Friday. Technical support personnel are available to all customers at no charge by telephone, facsimile and e-mail to answer questions and solve problems relating to our products. Our technical support personnel are trained in all aspects of our products. Our support staff is located at our headquarters in Simi Valley, California. We sell service contracts for on-site service of our tape libraries installed within the United States and Canada, which are fulfilled by IBM Corporation and on-site service contracts sold in Europe are fulfilled by Eastman Kodak S.A. Commercial Imaging Group.

- *Sales engineering.* Our engineers provide both pre-and post-sales support to our resellers. Engineers typically become involved in more complex problem-solving situations involving interactions between our products, third-party software, network server hardware and the network operating systems. Engineers work with resellers and end users over the telephone and at an end user site as required.

- *Training.* We offer a product maintenance training program for end users, value added resellers, original equipment manufacturers, customer service and technical support personnel. We conduct training classes at our headquarters and on-site as appropriate.

- *Warranty.* The warranty period on our tape libraries is three years. Some TLS and all RLS models have three year advance replacement warranty coverage that provides for replacement of components or, if necessary, complete libraries. All other TLS models have a one year advance replacement warranty with the second and third year being return-to-factory for service at no charge. Customers may purchase extended advance replacement service coverage and on-site service if they are located in the United States, Canada and some countries within Europe.

Manufacturing and Suppliers

We manufacture all of our tape libraries at our facility in Simi Valley, California. We currently operate five assembly lines during one daily eight-hour shift. As needs require, we have the ability to add a second or third shift to increase our capacity.

To respond rapidly to orders, we build our tape libraries to a semi-finished state, perform full testing and then place the tape libraries in a holding area until an order is received. Once an order is confirmed, we remove the unit from the holding area, install tape drives and configure the unit to meet the specific requirements of the order, retest and then ship.

The manufacturing cycle to bring the libraries to a semi-finished state is approximately five working days. We believe that this process represents an effective way to control our inventory levels while maintaining the ability to fill specific orders in short lead times. We coordinate inventory planning and management with suppliers and customers to match our production to market demand. Once we confirm an order, we generally ship the product within one to three working days. We believe this response time is among the fastest in the industry and gives us a competitive edge. Because we fill the majority of our orders as they are received, our backlog generally is small and is not indicative of future revenues.

We carefully select our suppliers based on their ability to provide quality parts that meet our specifications and volume requirements. Inventory planning and management is coordinated closely with suppliers to match our production needs. Many of the components assembled into our libraries are off-the-shelf parts, which reduces the risk of part shortages and allows us to maintain inventory of these parts at a minimum. A number of our component parts are not available off the shelf, but are designed to our specifications for integration into our products.

Tape drives and tape media are available only from a limited number of suppliers, some of which are sole-source providers. Some of our suppliers compete with us by selling their own tape libraries. The risk of allocation is greater upon the introduction of a new tape drive technology. Any disruption in supplies of tape drives or tape media could delay shipments of our products.

Competition

The market for automated tape libraries is intensely competitive and characterized by rapidly changing technology and evolving standards. Because we offer a broad range of libraries for different tape drive technologies, we tend to have a large number of competitors that differ depending on the particular format and performance level. We compete in a segment of the overall tape library market that focuses on small to mid-range network computing environments. Our principal competitors in this market segment include Sun/StorageTek, Quantum Corporation, Advanced Digital Information Corporation, Overland Storage, Inc., and Spectra Logic Corporation.

Many of our competitors have substantially greater financial and other resources, better name recognition, larger research and development staffs, and more capabilities in manufacturing, marketing and distributing products than we do. Our competitors may develop new technologies and products that are more effective than our products. We are not ISO-9000 certified, unlike some of our competitors, which may limit some customers' ability to purchase our products.

As competitors introduce products in a particular tape drive technology, the increased competition normally results in price erosion and a reduction in gross margins for all competitors. We cannot assure you that we will be able to compete successfully against either current or potential competitors or that competition will not cause a reduction in our revenues or profit margins. We believe that our ability to compete depends on a number of factors, including the success and timing of new product developments by us and by our competitors, compatibility of our products with a broad range of computing systems, product performance, reliability, price, marketing and sales execution and customer support. Specifically, we believe that the principal competitive factors in the selection of a tape library include:

- reliability of the robotic assembly that handles the tape cartridges;
- initial purchase price;
- storage capacity;
- speed of data transfer;
- compatibility with existing operating systems and storage management software;
- after-sale expandability of a tape library to meet increasing storage requirements;
- expected product life, cost of maintenance and total cost of ownership; and
- physical configuration and power requirements of the library.

We believe our tape libraries compete favorably overall with respect to many of these factors.

Research and Development

Our research and development group of 21 people consists of engineers and technicians who have data storage and related industry experience. We have developed over 40 separate tape library models for eleven different tape formats over the last ten years.

Our research and development efforts rely on the integration of multiple engineering disciplines to generate products that meet market needs in a competitive and timely fashion. Successful development of automated tape libraries requires the integration of mechanical design, electronic design packaging, software design, and firmware design into a single product. Product success also relies on the engineering group's thorough knowledge of each of the different tape drive technologies.

We frequently develop new products in response to the availability of a new tape drive technology. As tape drive manufacturers compete in the marketplace, they continually invest in research and development to gain performance leadership either by offering increasingly enhanced versions of their current tape drive products or by introducing an entirely new tape drive technology. We benefit from these industry developments by utilizing the new technology in our products. Our engineers work closely with the tape drive manufacturers through the drive development cycle to assure that reliable tape library and tape drive combinations are brought to market.

The design architecture of our tape libraries makes use of common parts across most product families, allowing us to develop and introduce new products quickly. If a new tape drive is an advanced version of one already incorporated in one or more of our products, our time and dollar investment to incorporate the new drive can be relatively small, with the primary focus being on verification testing. When the form factors differ, the time and investment requirements can grow substantially, and may require development of a new product family altogether.

We also develop new products as we identify emerging market needs. Our sales, marketing, product development and engineering groups identify products to fulfill customer and marketplace needs. Our research and development group concentrates on leveraging previous engineering investments into new products. For example, our firmware is based on successive generations of the operating system developed for our first library. We also use common parts in our different library series and leverage our electro-mechanical and electronic hardware technology from previous products into next generation designs. In some cases, entire subassemblies are transferable, leveraging not only engineering time but also materials purchasing, inventory stocking and manufacturing efforts.

Our research and development expenses were approximately $3.8 million in fiscal 2005, approximately $4.3 million in fiscal 2004, and approximately $4.0 million in fiscal 2003. We anticipate research and development costs to be slightly lower in fiscal 2006.

Intellectual Property

We rely on copyright protection of our firmware, as well as patent protection for some of our designs and products. We also rely on a combination of trademark, trade secret and other intellectual property laws to protect our proprietary rights. However, we do not believe our intellectual property provides significant protection from competition. We believe that, because of the rapid pace of technological change in the tape storage industry, patent, copyright, trademark and trade secret protection are less significant than factors such as the knowledge, ability and experience of our personnel and timely new product introductions.

We enter into Employee Proprietary Information and Inventions Agreements with our engineers along with all employees and consultants to protect our technology and designs. However, we do not believe that such protection can preclude competitors from developing substantially equivalent products.

Employees

As of September 26, 2005, we had 95 full-time employees, including 35 in operations and manufacturing, 22 in research and development, 6 in customer service and technical support, 17 in sales and marketing, and 15 in administration and finance. We also employ a small number of temporary employees and consultants as needed. We are not a party to any collective bargaining agreement or other similar agreement. We believe that we have a good relationship with our employees.

RISK FACTORS

Our principal competitors devote greater financial resources to developing, marketing and selling automated tape libraries. Consequently, we may be unable to maintain or increase our market share.

We face significant competition in developing and selling automated tape libraries. Rapid and ongoing changes in technology and product standards could quickly render our products less competitive, or even obsolete. We have significantly fewer financial, technical, manufacturing, marketing and other resources than many of our competitors and these limited resources may harm our business in many ways. For example, in the past several years our competitors have:

- acquired other tape library companies;
- increased the geographic scope of their market;
- offered a wider range of tape library products; and
- developed and acquired proprietary software and disk based products that operate in conjunction with their products and the products of their competitors.

In the future, our competitors may leverage their greater resources to:

- develop, manufacture and market products that are less expensive or technologically superior to our products;
- attend more trade shows and spend more on advertising and marketing;
- reach a wider array of potential customers through a broader range of distribution channels;
- respond more quickly to new or changing technologies, customer requirements and standards; or
- reduce prices in order to preserve or gain market share.

We believe competitive pressures are likely to continue. We cannot guarantee that our resources will be sufficient to address this competition or that we will manage costs and adopt strategies capable of effectively utilizing our resources. If we are unable to respond to competitive pressures successfully, our prices and profit margins may fall and our market share may decrease.

We have a limited number of executives. The loss of any single executive or the failure to hire and integrate capable new executives could harm our business.

The success of our business is tied closely to the managerial, engineering and business acumen of our existing executives. William J. Gervais, our President, has been largely responsible for the development of most of our tape libraries, has overseen our operations and growth, and established and maintained our strategic relationships. We expect that he will continue these efforts for the foreseeable future. Our future success will also depend on our ability to attract, retain and motivate key executives and other key personnel, many of whom have been instrumental in developing new technologies and strategic plans. We may not be able to retain our existing personnel or attract additional qualified personnel in the future. However, our current dependence on a limited number of executives and other key personnel, for whom replacements may be difficult to find, entails a risk that we may not be able to supervise and manage our ongoing operations.

Our suppliers could reduce shipments of tape drives and tape media. If this occurs, we would be forced to curtail production, our revenues could fall and our market share could decline.

Automated tape libraries and related products, such as tape drives and tape media, represented approximately 75.1% of our revenues for fiscal 2005, approximately 81.4% of our revenues for fiscal 2004, and approximately 79.8% of our revenues for fiscal 2003. We depend on a limited number of third-party manufacturers to supply us with the tape drives and tape media that we incorporate into our automated tape libraries. Some tape drive manufacturers, including Sony Corporation and Quantum Corporation, compete with us by also manufacturing tape libraries. There can be no assurance that other tape drive manufacturers will not also begin to manufacture libraries.

Historically, some of these suppliers have been unable to meet demand for their products and have allocated their limited supply among customers. If suppliers limit our supply of tape drives or tape media, we may be forced to delay or cancel shipments of our tape libraries. The major supplier risks we face include the following:

- Sony Electronics, Inc. is our sole-source supplier of AIT and Super AIT drives and media. In the past, Sony has allocated some of their products and may allocate them again in the future. In fiscal 2005 we derived approximately $12.0 million or 47.8% of our revenues, in fiscal 2004 we derived approximately $16.1 million, or 51.1%, of our revenues, and in fiscal 2003 we derived approximately $18.9 million, or 56.2% of revenues from the sale of libraries, tape drives and tape media based on Sony AIT and Super AIT technologies. If Sony reduces its sales to us or raises its prices, we could lose revenues and our margins could decline.
- Quantum Corporation is our sole-source supplier of SuperDLT tape drives and competes with us as a manufacturer of automated tape libraries. In the past, Quantum has allocated quantities of tape drives among its customers. It is possible that Quantum will allocate again, and as a result, may be unable to meet our future SuperDLT tape drive requirements.
- The LTO standard was developed by an industry consortium consisting of IBM, Hewlett Packard and Quantum/Certance. LTO competes with AIT and other half-inch tape drives and media. All three drive suppliers also sell automated tape libraries that utilize LTO tape drives and compete with our products. Therefore, even if we receive adequate allocation, it may be at a price that renders our products uncompetitive.

Our other suppliers have in the past been, and may in the future be, unable to meet our demand, including our needs for timely delivery, adequate quantity and high quality. We do not have long-term supply contracts with any of our significant suppliers. The partial or complete loss of any of our suppliers could result in lost revenue, added costs and production delays or could otherwise harm our business and customer relationships.

Our revenues could decline if we fail to execute our distribution strategy successfully.

We distribute and sell our automated tape libraries primarily through value added resellers and original equipment manufacturers, and intend to continue this strategy for the foreseeable future. Value added resellers integrate our tape libraries with products of other manufacturers and sell the combined products to their own customers. Original equipment manufacturers combine our tape libraries with their own products and sell the combined product under their own brand. We currently devote, and intend to continue to devote, significant resources to develop these relationships. A failure to initiate, manage and expand our relationships with value added resellers or original equipment manufacturers could limit our ability to grow or sustain our current level of revenues.

Our focus on the distribution of our products through value added resellers poses the following risks:

- we may reach fewer customers because we depend on value added resellers to market to end users and these value added resellers may fail to market effectively or fail to devote sufficient or effective sales, marketing and technical support to the sales of our products;
- we may lose sales because many of our value added resellers sell products that compete with our products. These value added resellers may reduce their marketing efforts for our products in favor of products manufactured by our competitors;
- our costs may increase as value added resellers generally require a higher level of customer support than do original equipment manufacturers; and
- as the market for tape libraries matures, we expect that tape libraries designed for small and medium size businesses will not require the level of sales, marketing and technical support traditionally provided

by value added resellers and, consequently, tape libraries for these customers will be increasingly sold through distribution channels rather than through value added resellers.

We depend upon our original equipment manufacturer customers' ability to develop new products, applications and product enhancements that incorporate our products in a timely, cost-effective and customer-friendly manner. We cannot guarantee that our original equipment manufacturer customers will meet these challenges effectively. Original equipment manufacturers typically conduct substantial and lengthy evaluation programs before certifying a new product for inclusion in their product line. We may be required to devote significant financial and human resources to these evaluation programs with no assurance that our products will ever be selected. In addition, even if selected by the original equipment manufacturer, there generally is no requirement that the original equipment manufacturer purchase any particular amount of product from us or that it refrain from purchasing competing products.

We do not have any exclusive agreements with our value added resellers or original equipment manufacturers, who purchase our products on an individual purchase order basis. If we lose important value added resellers or original equipment manufacturer customers, if they reduce their focus on our products or if we are unable to obtain additional value added reseller or original equipment manufacturer customers, our business could suffer.

We rely on tape technology for substantially all of our revenues. Our business will be harmed if demand for storage solutions using tape technology declines or fails to develop as we expect.

We derive substantially all of our revenues from products that incorporate some form of tape technology. We expect to derive substantially all of our revenues from these products for the foreseeable future. As a result, we will continue to be subject to the risk of a decrease in revenues if demand for these products declines or if rising prices make it more difficult to obtain them. If products incorporating other technologies gain comparable or superior market acceptance and competitive price advantage, our business, financial condition and operating results could be adversely and materially affected unless we successfully develop and market products incorporating the new technology.

We depend upon the AIT and Super AIT tape formats supplied by Sony Electronics Inc. for a significant portion of our revenues. Should Sony abandon or fail to advance this tape format, future revenues or operating results could suffer.

Sony Electronics Inc. is our sole supplier of AIT and Super AIT tape drives and tape media. If Sony should discontinue manufacturing these products or fail to advance the technology to keep pace with the industry trend of increasing tape capacity, our revenues or operating results could be significantly impacted.

Our revenues and operating results may fluctuate unexpectedly from quarter to quarter, which may cause our stock price to decline.

Our quarterly revenues and operating results have fluctuated in the past, and are likely to vary significantly in the future due to several factors, including:

- general economic conditions affecting spending for information technology;
- increased competition and pricing pressures;
- reductions in the size, delays in the timing, or cancellation of significant customer orders;
- shifts in product or distribution channel mix;
- the timing of the introduction or enhancement of products by us, our original equipment manufacturer customers or our competitors;
- expansions or reductions in our relationships with value added reseller and original equipment manufacturer customers;

- financial difficulties affecting our value added reseller or original equipment manufacturer customers that render them unable to pay amounts owed to us;
- increased number and diversity of available data back-up and archive storage alternatives resulting in delays to customer decision-making cycles;
- market acceptance of new and enhanced versions of our products;
- new product developments by storage device manufacturers, including cost and performance of disk drive products;
- the rate of growth in the data storage market and the various segments within it;
- timing and levels of our operating expenses; and
- availability of tape media and key components and performance of key suppliers.

We believe that period to period comparisons of our operating results may not necessarily be reliable indicators of our future performance. It is likely that in some future period our operating results will not meet your expectations or those of public market analysts.

Any unanticipated change in revenues or operating results is likely to cause our stock price to fluctuate since such changes reflect new information available to investors and analysts. New information may cause investors and analysts to revalue our stock and this, in the aggregate, may cause fluctuations in our stock price.

Our lack of significant order backlog makes it difficult to forecast future revenues and operating results.

We normally ship products within a few days after orders are received. Consequently, we do not have significant order backlog and a large portion of our revenues in each quarter results from orders placed during that quarter. Because backlog can be an important indicator of future revenues, our lack of backlog makes it more difficult to forecast our future revenues. Since our operating expenses are relatively fixed in the short term, unexpected fluctuations in revenues could negatively impact our quarterly operating results.

If we fail to develop and introduce new products on a timely and cost-effective basis, or if our products do not contain the features required by the marketplace, we will eventually lose market share and sales to more innovative competitors.

The market for our products is characterized by rapidly changing technology and evolving industry standards. The future success of Qualstar will depend on our ability to anticipate changes in technology, to develop new and enhanced products on a timely and cost-effective basis, and to introduce, manufacture and achieve market acceptance of these new and enhanced products. In particular, our success will depend on the market acceptance of our soon to be introduced XLS family of automated tape libraries, our "next generation of automated tape libraries" designed for the enterprise marketplace. Our RLS and TLS families of tape libraries are facing increasing competition from products manufactured by our competitors and may face competition from other types of storage devices that may be developed in the future.

Development schedules for high technology products are inherently subject to uncertainty and there can be no assurance we will be able to meet our product development schedules or that our development costs will be within budgeted amounts. If the products or product enhancements developed are not deliverable due to technical problems, quality issues or component shortages, or if such products or product enhancements are not accepted by the marketplace or are unreliable, then our business, financial condition and results of operations may be materially adversely affected.

The introduction of new storage technologies or the adoption of an industry standard different than our current product standards could render our existing products obsolete.

Our increased research and development spending may not yield results that justify the costs incurred.

In recent fiscal years we have substantially increased our research and development spending over that of prior periods. Our products and markets are technologically advanced and rapidly evolving, and we cannot be assured that these efforts will successfully provide us with new or upgraded products that will be competitive. If these programs are not successful, our increased investment in research and development will not yield corresponding benefits to us.

We depend upon independent software vendors to provide management software that makes our tape libraries functional.

The utility of an automated tape library depends partly upon the storage management software, which supports the library and integrates it into the user's computing environment to provide a complete storage solution. We do not develop and have no control over the development of this storage management software. Instead we rely on third party independent software vendors to develop and support this software. Accordingly, the continued development and future growth of the market for our products will depend partly upon the success of software vendors to meet the overall data storage and management needs of tape library purchasers and our ability to maintain relationships with these firms. Although we do not have contracts with any third party independent software vendors, we maintain relationships with them by:

- supplying tape libraries so they can qualify their software to work with our tape libraries;
- evaluating their software for compatibility with our tape libraries;
- keeping them informed as to current and contemplated changes to our products; and
- referring business to them when value added resellers or end users inquire about software sources.

Our customers have the right to return our products in certain circumstances. An excessive number of returns may reduce our revenues.

Our customers have 30 days from the date of purchase to return products that do not conform to an end user's requirements. We may otherwise allow product returns if we think that doing so maximizes the effectiveness of our sales channels and promotes our reputation for quality and service.

Although we estimate and reserve for potential returns in our reported financial results, actual returns could exceed our estimates. If the number of returns exceeds our estimates, our financial results could be adversely impacted for the periods during which returns are made.

We may spend money pursuing sales that do not occur when anticipated or at all.

Original equipment manufacturer customers typically conduct significant evaluation, testing, implementation and acceptance procedures before they begin to market and sell new models of tape libraries. This evaluation process is lengthy and may range from six months to one year or more. This process is complex and may require significant sales, marketing, engineering and management resources on our part. The process becomes more complex as we simultaneously qualify our products with multiple customers or pursue large orders with a single customer. As a result, we may expend resources to develop customer relationships before we recognize any revenue from these relationships, if at all.

We sell a significant portion of our products to customers located outside the United States. Currency fluctuations and increased costs associated with international sales could make our products unaffordable in foreign markets, which would reduce our revenue or profitability.

Revenues from shipments to customers outside of North America accounted for approximately 27.3% of revenues in fiscal 2005, approximately 32.4% of revenues in fiscal 2004, and approximately 29.4% of revenues in fiscal 2003. We believe that international sales will continue to represent a significant portion of our revenues. Our international sales subject us to a number of risks, including:

- political and economic instability may reduce demand for our products or our ability to market our products in foreign countries;
- although we denominate our international sales in U.S. dollars, currency fluctuations could make our products unaffordable to foreign purchasers or more expensive compared to those of foreign manufacturers;
- restrictions on the export or import of technology may reduce or eliminate our ability to sell in certain markets;
- the need to comply with a wide variety of foreign laws and regulations;
- greater difficulty of administering business overseas may increase the costs of foreign sales and support;
- foreign governments may impose tariffs, quotas and taxes on our products;
- longer payment cycles typically associated with international sales and potential difficulties in collecting accounts receivable may reduce the profitability of foreign sales; and
- our current determination not to seek ISO-9000 certification, a widely accepted method of establishing and certifying the quality of a manufacturer's operations, may reduce sales.

These risks may increase our costs of doing business internationally and reduce our revenues or profitability.

We may have to expend significant amounts of time and money defending or settling product liability claims arising from failures of our tape libraries.

Because our tape library customers use our products to store and backup their important data, we face potential liability if our products fail to perform. Although we maintain general liability insurance, our insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed. Any imposition of liability that is not covered by insurance or that exceeds our insurance coverage could reduce our profitability or cause us to discontinue operations.

A failure to develop and maintain proprietary technology may negatively affect our business.

We rely on copyright protection of electronic circuits and our firmware, as well as patent protection for some of our designs and products. We also rely on a combination of trademark, trade secret, and other intellectual property laws and various contract rights to protect our proprietary rights. However, we do not believe our intellectual property rights provide significant protection from competition. As a consequence, these rights may not preclude competitors from developing products that are substantially equivalent or superior to our products. In addition, many aspects of our products are not subject to intellectual property protection and therefore can be reproduced by our competitors.

Intellectual property infringement claims brought against us could be time consuming and expensive to defend.

In recent years, there has been an increasing amount of litigation in the United States involving patents and other intellectual property rights. Qualstar is not currently directly involved in any intellectual property litigation or proceedings. However, in April 2004 we settled litigation that Raytheon Company had filed alleging that Qualstar and eight other named defendants infringed on a patent owned by Raytheon Company entitled "Mass Data Storage Library." In the future, we may become subject to other claims or inquiries regarding our alleged unauthorized use of a third party's intellectual property. An adverse outcome in litigation could force us to do one or more of the following:

- stop selling, incorporating or using our products or services that use the challenged intellectual property;
- subject us to significant liabilities to third parties;
- obtain from the owners of the infringed intellectual property right a license to sell or use the relevant technology, which license may not be available on reasonable terms, or at all; or
- redesign those products or services that use the infringed technology, which redesign may be either economically or technologically infeasible.

Whether or not an intellectual property litigation claim is valid, the cost of responding to it, in terms of legal fees and expenses and the diversion of management resources, could harm our business.

Undetected software or hardware flaws could increase our costs, reduce our revenues and divert resources from our core business needs.

Our tape libraries are complex. Despite our efforts to revise and update our manufacturing and test processes to address engineering and component changes, we may not be able to control and eliminate manufacturing flaws adequately. These flaws may include undetected software or hardware defects associated with:

- a newly introduced product;
- a new version of an existing product; or
- a product that has been integrated into a network storage solution with the products of other vendors.

The variety of contexts in which errors may arise may make it difficult to identify the source of a problem. These problems may:

- cause us to incur significant warranty, repair and replacement costs;
- divert the attention of our engineering personnel from our product development efforts;
- cause significant customer relations problems; or
- damage our reputation.

To address these risks, we frequently revise and update manufacturing and test procedures to address engineering and component changes to our products. If we fail to adequately monitor, develop and implement appropriate test and manufacturing processes we could experience a rate of product failure that results in substantial shipment delays, repair or replacement costs or damage to our reputation. Product flaws may also consume our limited engineering resources and interrupt our development efforts. Significant product failures would increase our costs and result in the loss of future sales and be harmful to our business.

Our warranty reserves may not adequately cover our warranty obligations.

We have established reserves for the estimated liability associated with our product warranties. However, we could experience unforeseen circumstances where these or future reserves may not adequately cover our warranty obligations.

Our officers and directors could implement corporate actions that are not in the best interests of our shareholders as a whole.

Our executive officers and directors own beneficially, in the aggregate, approximately 45% of our outstanding common stock as of June 30, 2005. As a result, these shareholders will be able to exercise significant control over all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us. The interests of our officers and directors, when acting in their capacity as shareholders, may lead them to:

- vote for the election of directors who agree with the incumbent officers' or directors' preferred corporate policy; or
- oppose or support significant corporate transactions when these transactions further their interests as incumbent officers or directors, even if these interests diverge from their interests as shareholders per se and thus from the interests of other shareholders.

Some provisions of our charter documents may make takeover attempts difficult, which could depress the price of our stock and inhibit your ability to receive a premium price for your shares.

Our board of directors has the authority, without any action by the shareholders, to issue up to 5,000,000 shares of preferred stock and to fix the rights and preferences of such shares. In addition, our articles of incorporation and bylaws contain provisions that eliminate cumulative voting in the election of directors and require shareholders to give advance notice if they wish to nominate directors or submit proposals for shareholder approval. These provisions may have the effect of delaying, deferring or preventing a change in control, may discourage bids for our common stock at a premium over its market price and may adversely affect the market price, and the voting and other rights of the holders of our common stock.

We do not currently intend to pay dividends and therefore you will only be able to recover your investment in our common stock, if at all, by selling the shares of the stock that you own.

We historically have pursued a policy of reinvesting our earnings in research and development, expanding our value added reseller and original equipment manufacturer relationships, and expanding our manufacturing capabilities. Consequently, we have never paid dividends on our shares of capital stock. We currently intend to continue this policy for the foreseeable future to strengthen our financial and competitive position in the tape library market.

Trading in our stock has been limited and our stock price has been volatile. Consequently, it may be difficult to sell your shares.

There has been very little trading in shares of our stock and some days it does not trade at all. This, as well as the factors listed below, has caused the price of our stock to be very volatile. Consequently, it may be difficult to sell your shares of our stock at the price you paid for them or at a price equal to that quoted in the Nasdaq National Market. Factors that may cause our stock price to fluctuate in the future include:

- quarterly variations in operating results, especially if they differ from our previously announced forecasts or forecasts made by analysts;
- our announcements of anticipated future revenues or operating results;
- announcements concerning us, our competitors, our customers, or our industry;
- the introduction of new technology or products by us or our competitors;
- comments regarding us and the data storage market made by industry analysts or on Internet bulletin boards;
- changes in earnings estimates by analysts or changes in accounting policies;
- changes in product pricing policies by us or our competitors; and
- changes in general economic conditions.

In addition, stock markets have experienced extreme price and volume volatility in recent years. This volatility has had a substantial effect on the market prices of securities of many smaller public companies for reasons frequently unrelated or disproportionate to the operating performance of the specific companies. These market fluctuations may adversely affect the market price of our common stock.

EXECUTIVE OFFICERS OF THE REGISTRANT

Executive Officers

Officers are elected by and serve at the discretion of the board of directors. The executive officers of Qualstar as of September 26, 2005 are:

Name	Age	Position
William J. Gervais	62	Chief Executive Officer, President and Director
Richard A. Nelson	62	Vice President of Engineering, Secretary and Director
Frederic T. Boyer	61	Vice President and Chief Financial Officer
David L. Griffith	49	Vice President of Operations
Robert K. Covey	58	Vice President of Marketing
Robert C. King	61	Vice President of Sales

Background

William J. Gervais is a founder of Qualstar and has been our President and a director since our inception in 1984, and was elected Chief Executive Officer in January 2000. From 1984 until January 2000, Mr. Gervais also served as our Chief Financial Officer. From 1981 until 1984, Mr. Gervais was President of Northridge Design Associates, Inc., an engineering consulting firm. Mr. Gervais was a co-founder, and served as Engineering Manager from 1976 until 1981, of Micropolis Corporation. Mr. Gervais earned a B.S. degree in Mechanical Engineering from California State Polytechnic University, Pomona in 1967.

Richard A. Nelson is a founder of Qualstar and has been our Vice President of Engineering, Secretary and a director since our inception in 1984. From 1974 to 1984, Mr. Nelson was self employed as an engineering consultant specializing in microprocessor technology. Mr. Nelson earned a B.S. in Electronic Engineering from California State Polytechnic University, Pomona in 1966.

Frederic T. Boyer has been our Vice President and Chief Financial Officer since October, 2002. Prior to joining us, Mr. Boyer was Vice President and Chief Financial Officer of Accelerated Networks from 1998 to 2001. From May 1997 to October 1998, Mr. Boyer was the Senior Vice President, Finance and Administration and Chief Financial Officer of Software Dynamics. From January 1996 to May 1997, Mr. Boyer was a consultant to several technology companies. From March 1990 to January 1996, Mr. Boyer was Vice President and Chief Financial Officer of Fibermux Corporation, a networking company later acquired by ADC Telecommunications. Mr. Boyer holds an M.B.A. from Loyola University, a B.S. in Accounting from California State University, Los Angeles, and a B.S. in Economics from California State Polytechnic University, Pomona.

David L. Griffith, currently our Vice President of Operations, joined the company in October of 2001. From 1999 to 2001, Mr. Griffith served as the President and Chief Executive Officer of Stardrive Solutions Inc., a software solutions provider for the broadcast automation industry. From 1998 to 1999, Mr. Griffith was the Corporate Vice President of Business Development at Tandberg Data ASA where he was responsible for the development of worldwide business plans and corporate expansion activities. From 1994 to 1998, Mr. Griffith was the President and Chief Executive Officer of Tandberg Data, Inc. located in Simi Valley, California. From 1990 to 1994, Mr. Griffith was the Vice President of Sales and Marketing for Tandberg Data, Inc. From 1987 to 1990, Mr. Griffith acted as Marketing Manager and Program Manager for the Memory Products Group of Siemens Information Systems. Mr. Griffith received a degree in Mechanical Engineering from California State Polytechnic University in 1980.

Robert K. Covey has been our Vice President of Marketing since 1994. From 1986 to 1993 Mr. Covey was regional manager of ATG Cygnet, an optical disk library firm. From 1982 to 1985, Mr. Covey served as national sales manager at Micropolis Corporation, a former disk drive manufacturer. Mr. Covey attended Butler University and Bentley College from 1965 to 1968.

Robert C. King was appointed our Vice President of Sales in June 2005. From 1999 until it was acquired by JDS Uniphase in 2004, Mr. King was Vice President, Sales for E2O Communications, a manufacturer of optical transceivers. From 1995 to 1998 Mr. King was Vice President, Sales and Marketing for Advanced

Photonix. From 1992 to 1995, Mr. King served as Vice President, Sales and Marketing for Performance Materials Corporation. From 1989 to 1992, Mr. King served as Vice President, Market and Business Development for PCO, a subsidiary of Corning Incorporated. Mr. King holds a B.S.M.E. degree from Ohio University in Athens, Ohio.

Item 2. *Properties*

Our headquarters, located in Simi Valley, California, consists of a single building containing approximately 57,000 square feet housing our manufacturing, sales and marketing, finance and administration and approximately half of our engineering. Our lease on this facility expires in February 2011, with an early termination option becoming available in February of 2007. Rent on this facility is $39,000 per month, with step-ups ranging from $2,400 to $2,800 per month every two years.

We also lease approximately 4,300 square feet of office space in Boulder, Colorado, that houses our Advanced Development Group. The lease of the Boulder, Colorado facility expires in 2007. Additionally, we have a sales office in Surrey, United Kingdom.

Item 3. *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. We cannot assure you that we will not be adversely affected in the future by legal proceedings.

Item 4. *Submission of Matters to a Vote of Shareholders*

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended June 30, 2005.

PART II

Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Qualstar's common stock is quoted on the NASDAQ Stock Market's National Market (NASDAQ Symbol — QBAK). The following table sets forth the high and low closing sale prices of our common stock as reported by NASDAQ, during the periods indicated:

Period	Date Range	High	Low
Fiscal 2005:			
First Quarter	July 1 — September, 30, 2004	$6.44	$5.00
Second Quarter	October 1 — December 31, 2004	$6.94	$4.33
Third Quarter	January 1 — March 31, 2005	$5.00	$4.00
Fourth Quarter	April 1 — June 30, 2005	$4.55	$3.53
Fiscal 2004:			
First Quarter	July 1 — September, 30, 2003	$6.23	$4.75
Second Quarter	October 1 — December 31, 2003	$5.40	$4.25
Third Quarter	January 1 — March 31, 2004	$6.10	$4.56
Fourth Quarter	April 1 — June 30, 2004	$6.88	$5.25

There were approximately 49 owners of record of Qualstar's common stock as of September 16, 2005.

Qualstar has declared no cash dividends during the periods reported. Qualstar does not currently anticipate paying cash dividends in the foreseeable future, but intends to retain any future earnings for reinvestment in its business. Any future determination to pay cash dividends will be at the discretion of our Board of Directors and will be dependent upon Qualstar's financial condition, results of operations, capital requirements, terms of any debt instruments then in effect and such other factors as our Board of Directors may deem relevant at the time.

Item 6. ***Selected Financial Data***

The following selected financial data is qualified in its entirety by and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the financial statements and notes thereto included elsewhere in this 10-K. Our historical financial results are not necessarily indicative of results to be expected for any future period.

	Years Ended June 30,				
	2005	2004	2003	2002	2001
	(In thousands, expect per share amounts)				
Statements of Income Data:					
Net revenues	$25,144	$31,530	$33,557	$37,631	$51,572
Cost of goods sold	16,529	19,575	21,171	23,753	33,216
Gross profit	8,615	11,955	12,386	13,878	18,356
Operating expenses:					
Research and development	3,750	4,268	3,994	2,136	1,279
Sales and marketing	3,350	3,607	3,834	3,048	3,399
General and administrative	3,955	5,420	4,428	5,222	3,301
Total operating expenses	11,055	13,295	12,256	10,406	7,979
Income (loss) from operations	(2,440)	(1,340)	130	3,472	10,377
Investment income	858	624	693	1,133	1,225
Impairment loss for other-than-temporary decline in investments	—	(160)	—	—	—
Impairment of investment	—	—	—	—	(1,050)
Income (loss) before income taxes	(1,582)	(876)	823	4,605	10,552
Provision (benefit) for income taxes	65	(145)	274	1,845	3,824
Net income (loss)	$(1,647)	$ (731)	$ 549	$ 2,760	$ 6,728
Earnings (loss) per share:					
Basic	$ (0.13)	$ (0.06)	$ 0.04	$ 0.22	$ 0.54
Diluted	$ (0.13)	$ (0.06)	$ 0.04	$ 0.22	$ 0.53
Shares used to compute earnings (loss) per share:					
Basic	12,398	12,577	12,579	12,475	12,372
Diluted	12,398	12,577	12,666	12,664	12,668

	June 30,				
	2005	2004	2003	2002	2001
	(In thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$12,210	$ 6,401	$ 6,236	$ 4,859	$11,509
Marketable securities	21,854	29,376	29,857	25,987	15,578
Working capital	43,275	46,534	47,191	46,507	43,382
Total assets	47,223	51,647	52,096	50,758	47,878
Total debt	—	—	—	—	—
Shareholders' equity	44,653	48,064	48,868	47,973	44,689

Item 7. ***Management's Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion and analysis should be read in conjunction with our financial statements and notes thereto.

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 offer tape libraries for multiple tape drive technologies, including LTO, AIT, Super AIT, and SuperDLT tape drives and media.

Many enterprises now routinely manage very large databases, in addition to storing information on local desktop computers. This, coupled with the growth in the amount of data from new sources and applications, is increasing the need for managing and storing data efficiently. Anticipating the increased demand for tape libraries, we have developed tape libraries spanning a broad range of tape formats, prices, capacity and performance. We expect our products to continue to evolve in the future in response to emerging tape technologies and changing customer preferences.

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 who bundle our products with their own and sell them as part of a complete system or solution. We assist our customers with marketing, sales and technical support.

Our international sales efforts are currently directed from our corporate offices in Simi Valley, California. European sales are coordinated through our European sales office in the United Kingdom. All of our international sales are denominated in U.S. dollars. Revenues from sales outside North America were approximately $6.9 million, or 27.3% of revenues in fiscal 2005, approximately $10.2 million, or 32.4% of revenues in fiscal 2004, and approximately $9.9 million, or 29.4% of revenues in fiscal 2003.

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

Net revenues include revenues from the sale of tape libraries, library tape drives, tape cartridges, and ancillary products. Ancillary revenues include service, repair, on-site service agreements net of the cost of any third party service contracts, and power supplies. Automated tape libraries and related products, such as tape drives and tape media, represented approximately 75.1% of revenues in fiscal 2005, approximately 81.4% of revenues in fiscal 2004, and approximately 79.8% of revenues in fiscal 2003. Sales of ancillary products and services accounted for the balance of our revenues.

Gross margins depend on several factors, including the cost of manufacturing, product mix, customer demand and the level of competition. Larger tape libraries provide higher gross margins than do smaller tape libraries primarily because the competition is less intense in this market segment.

Research and development activities include the design and development of new products, as well as enhancements to existing products. Our engineering group is developing our next generation of automated tape libraries, currently in transition from the development phase to the pilot production phase, with manufacturing lines planned for our Simi Valley facility. We expect research and development expenses to decrease slightly in absolute dollars in the next fiscal year.

We expect general and administrative expenses to increase in fiscal 2006 due to expensing stock options under SFAS 123(R). We expect sales and marketing expenses to increase in fiscal 2006 due to additional expenses associated with bringing our next generation tape libraries to market.

We recorded deferred compensation of approximately $1.7 million in the third quarter of fiscal 2000, representing the difference between the exercise price of stock options and restricted stock granted to employees and directors during fiscal 2000 and the deemed fair value for accounting purposes of our common stock on the grant dates. Amortization of deferred compensation, which was recorded as general and administrative expense in the statement of operations, was $0 in fiscal 2005, approximately $140,000 during fiscal 2004, and approximately $301,000 in fiscal 2003. The deferred compensation related to these stock options and restricted stock was fully amortized as of June 30, 2004.

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 principals 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, 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 upon shipment of product to our customers. 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. In general, these customers are allowed to return the product, free of penalty, within thirty days of shipment, if the product does not meet the end user's requirements. Revenues from technical support services and other services are recognized at the time services are performed.

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.

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.

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.

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.

The Company had fiscal 2002 under audit by the Internal Revenue Service (“IRS”) for which the IRS issued a no change opinion in the quarter ended March 31, 2005.

Results of Operations

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

	Years Ended June 30,		
	2005	2004	2003
Net revenues	100.0%	100.0%	100.0%
Cost of goods sold	65.7	62.1	63.1
Gross margin	34.3	37.9	36.9
Operating expenses:			
Research and development	14.9	13.5	11.9
Sales and marketing	13.4	11.4	11.4
General and administrative	15.7	17.2	13.2
Income (loss) from operations	(9.7)	(4.2)	0.4
Investment income	3.4	2.0	2.0
Impairment loss for other-than-temporary decline in investments	—	(0.6)	—
Income (loss) before provision (benefit) for income taxes	(6.3)	(2.8)	2.4
Provision (benefit) for income taxes	0.3	(0.5)	0.8
Net income (loss)	(6.6)%	(2.3)%	1.6%

Revenues are recognized upon shipment of the product to the customer, less estimated returns, for which provision is made at the time of sale. The following table summarizes our revenue by major product line:

	Years Ended June 30,		
	2005	2004	2003
Tape Library revenues:			
TLS	51.7%	56.4%	67.7%
RLS	13.1	15.5	4.0
	64.8	71.9	71.7
Other revenues:			
Service	10.5	7.6	6.2
Media	10.3	9.5	8.1
Power Supplies	5.1	1.8	0.6
Upgrades, Spares, 9 Track	9.3	9.2	13.4
	100.0%	100.0%	100.0%

Fiscal 2005 Compared to Fiscal 2004

Net Revenues. Revenues are recognized upon shipment of the product to the customer, less estimated returns, for which provision is made at the time of the sale. Revenues for the year ended June 30, 2005 were $25.1 million, a decrease of 20.3% compared to net revenues of $31.5 million for the year ended June 30, 2004.

The decrease in revenues was due primarily to a decline in the demand for our tape libraries using 8mm AIT tape technology and to a lesser extent, half inch tape technology. Revenues from libraries incorporating AIT tape technology were lower due to customer preferences shifting to the higher capacity half inch technology tape drives, caused, in part, by the delayed availability of AIT4 tape drives. Moreover, when AIT4 tape drives did become available, they were not backward read-write compatible with earlier generations of AIT tape drives. Both of these factors negatively impacted our upgrade business in our large AIT customer base. Revenues incorporating half inch technology exceeded revenues incorporating 8mm technology in absolute dollars in fiscal 2005. In fiscal 2004, by comparison, revenues were divided about evenly between 8mm and half inch tape technologies in absolute dollars. However, revenues from libraries incorporating half inch technology decreased from fiscal 2004 as the second and third quarters of fiscal 2004 benefited from a large non-recurring library order of approximately $2.5 million.

Revenues from tape libraries and drives decreased to $16.3 million, or 64.8% of revenues, in the year ended June 30, 2005 from $22.7 million, or 71.9% of revenues, in the year ended June 30, 2004. Although selling prices of our libraries dropped during fiscal 2005, average selling prices of libraries increased during fiscal 2005 due to a change in product mix.

Gross Profit. Gross profit was $8.6 million, or 34.3% of revenues, for the year ended June 30, 2005, compared to $12.0 million, or 37.9% of revenues, for fiscal 2004. Cost of goods sold consists primarily of direct labor, purchased parts, depreciation of plant and equipment, rent, utilities, and packaging costs. The decrease in gross margin as a percentage of revenues was attributed to lower manufacturing overhead absorption due to lower revenues as well as to lower selling prices due to greater competitive pricing pressures.

Research and Development. Research and development expenses consist of engineering salaries, benefits, outside consultant fees, purchased parts, and supplies used in development activities. Research and development expenses for the year ended June 30, 2005 decreased to $3.8 million or 14.9% of revenues as compared to $4.3 million or 13.5% of revenues for the year ended June 30, 2004. This decrease in absolute dollars was due primarily to lower prototype material costs and salaries, partly offset by higher consulting costs, as the next generation of tape libraries transitions from the development phase to the pilot production phase.

Sales and Marketing. Sales and marketing expenses consist primarily of employee salaries, benefits, sales commissions, trade show costs, advertising and travel related expenses. Sales and marketing expenses decreased to $3.4 million, or 13.3% of revenues for the year ended June 30, 2005, as compared to $3.6 million, or 11.4% of revenues, for the year ended June 30, 2004. The decrease in absolute dollars can be attributed primarily to a reduction in advertising and outside commission expenses.

General and Administrative. General and administrative expenses include employee salaries and benefits, deferred compensation related to stock options and restricted stock, provision for doubtful accounts, and professional service fees. General and administrative expenses decreased to $4.0 million, or 15.7% of revenues for the year ended June 30, 2005 as compared to $5.4 million, or 17.2% of revenues for the year ended June 30, 2004. The decrease in general and administrative expenses was due to lower legal expenses attributed to the settlement of the Raytheon lawsuit in April 2004, lower bad debt expense and the absence of deferred stock compensation.

Investment Income and Impairment Loss for Other-than-Temporary Decline in Investments. Investment income increased to $858,000 for the year ended June 30, 2005 as compared to net investment income of $464,000 in fiscal 2004. The increase is attributed to lowering the average duration of our portfolio to capture the higher short-term yields available in the current higher interest rate environment. In addition, an impairment loss for other-than-temporary decline in investments of $160,000 was recognized in fiscal 2004 earnings due to the adoption of Emerging Issues Task Force No. 03-1.

Provision for Income Taxes. The provision for income taxes was $65,000, or –4.1% of pre-tax loss, for fiscal 2005 compared to a benefit of $145,000, or 16.6% of pre-tax loss, for fiscal 2004. The provision for income taxes in fiscal 2005 can be primarily attributed to establishing full valuation allowances against net deferred tax assets based on our assessment regarding the realizability of these benefits in future years offset by the recognition of research and development credits to be received. In fiscal 2004, the low effective tax benefit rate was primarily attributed to establishing valuation allowances for capital losses realized on a tax basis in fiscal 2004 and net operating loss carryforwards.

Fiscal 2004 Compared to Fiscal 2003

Net Revenues. Revenues for the year ended June 30, 2004 were $31.5 million, a decrease of 6.0% compared to net revenues of $33.6 million for the year ended June 30, 2003.

The decrease in revenues was due primarily to a decline in the demand for our tape libraries using 8mm AIT tape technology. This decrease was substantially offset by an increase in revenues from our libraries using half inch technology, such as LTO-2 and Super AIT. The most recent AIT tape technology has only half the native storage capacity of the most recent LTO-2 and other half inch tape technologies. We have been successful at incorporating half inch tape drives into our TLS libraries as well as the newer rack-mountable RLS libraries and shifting customer preferences to the half inch tape format. This resulted in revenues being divided about evenly between 8mm and half inch tape technologies in absolute dollars in fiscal 2004. In fiscal 2003, by comparison, revenues attributed to AIT tape technology in absolute dollars exceeded half inch technology by 44%.

Revenues from tape libraries and drives decreased to $22.7 million, or 71.9% of revenues, in the year ended June 30, 2004 from $24.1 million, or 71.7% of revenues, in the year ended June 30, 2003. Selling prices of our libraries remained relatively stable during fiscal 2004. Average selling prices of library tape drives increased during fiscal 2004 due to a change in product mix.

Gross Profit. Gross profit was $12.0 million, or 37.9% of revenues, for the year ended June 30, 2004, compared to $12.4 million, or 36.9% of revenues, for fiscal 2003. The increase in gross margin as a percentage of revenues was attributed to efficiencies achieved in material management; a more favorable product mix caused by the discontinuation of several lower margin libraries; and sales of media with higher than normal margins.

Research and Development. Research and development expenses for the year ended June 30, 2004 increased 6.9% to $4.3 million or 13.5% of revenues as compared to $4.0 million or 11.9% of revenues for the year ended June 30, 2003. This increase was due primarily to costs incurred in the continuing operating activities of our Advanced Development Group in Boulder, Colorado, established in late fiscal 2002 to design and develop our next generation of tape libraries.

Sales and Marketing. Sales and marketing expenses decreased by 5.9% to $3.6 million, or 11.4% of revenues for the year ended June 30, 2004, as compared to $3.8 million, or 11.4% of revenues, for the year ended June 30, 2003. Although the percent decrease is consistent with the decrease in revenues, in absolute dollars, the decrease can be attributed to a reduction in advertising costs due to a shift to the lower cost electronic advertising versus print advertising and lower co-operative advertising as well as a reduction in travel related expenditures.

General and Administrative. General and administrative expenses increased to $5.4 million for fiscal 2004 as compared to $4.4 million for fiscal 2003. As a percentage of revenues, general and administrative expenses increased to 17.2% for the year ended June 30, 2004 as compared to 13.2% for the year ended June 30, 2003. The increase in general and administrative expenses was due primarily to legal fees and settlement costs associated with our defense of the Raytheon lawsuit.

Investment Income and Impairment Loss for Other-than-Temporary Decline in Investments. Investment income, net of an impairment loss for other-than-temporary decline in investments of $160,000, decreased to $464,000 in the year ended June 30, 2004 as compared to $693,000 in the year ended June 30, 2003. This decrease was due primarily to the adoption of Emerging Issues Task Force No. 03-1, which resulted in recognizing an impairment loss for other-than-temporary decline in investments of $160,000 in earnings. In addition, the economy continues to experience low interest rates, which has had a negative impact on our portfolio's overall performance.

Provision for Income Taxes. The benefit for income taxes was $145,000, or 16.6% of pre-tax loss, for fiscal 2004 compared to a provision of $274,000, or 33.3% of pre-tax income, for fiscal 2003. The low effective tax benefit rate in fiscal 2004 can be primarily attributed to valuation allowances established for capital losses realized on a tax basis in fiscal 2004 and net operating loss carryforwards based on our assessment regarding the realizability of these benefits in future years.

Liquidity and Capital Resources

Historically, we have funded our capital requirements with cash provided by operations. Cash provided by operating activities was $.2 million in fiscal 2005, $.3 million in fiscal 2004, and $6.0 million in fiscal 2003. In fiscal 2005, operating cash was primarily provided by refunds of fiscal 2002 federal and state income taxes paid and a decrease in accounts receivable, offset partially by decreases in accounts payable and other accrued liabilities. In fiscal 2004, operating cash was primarily provided by a refund of fiscal 2003 income taxes paid and increases in accounts payable and other accrued liabilities, offset partially by increases in accounts receivable and inventories. In fiscal 2003, operating cash was primarily provided by reductions in accounts receivable and inventory.

Cash provided by investing activities was $7.3 million in fiscal 2005, and cash used in investing activities was $15,000 in fiscal 2004, and $4.7 million in fiscal 2003. Cash provided by investing activities in fiscal 2005 related primarily to sales of marketable securities partially offset by purchases of equipment. Cash used in investing activities for fiscal 2004 and 2003 related primarily to purchases of marketable securities as well as equipment and leasehold improvements.

Cash used in financing activities was $1.7 million in fiscal 2005, $.1 million in fiscal 2004 and cash provided by financing activities was $.05 million in fiscal 2003. Cash used in financing activities for fiscal 2005 and 2004, related primarily to repurchasing shares of the Company's common stock. Cash provided by financing activities in fiscal 2003 related primarily to principal and interest payments on directors' notes and proceeds from the exercise of stock options, partially offset by the repurchase of the Company's common stock.

As of June 30, 2005, we had $12.2 million in cash and cash equivalents and $21.9 million in marketable securities. We believe that our existing cash and cash equivalents and 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.

Summary of Contractual Obligations and Commitments

The following is a summary of our future payments due under contractual obligations as of June 30, 2005:

Year Ended June 30	Operating Leases	Purchase Obligations	Total
		(in thousands)	
2006	$ 581	$2,035	$2,616
2007	592	—	592
2008	554	—	554
2009	570	—	570
Thereafter	895	—	895
	$3,192	$2,035	$5,227

Purchase obligations in the table above represent the value of open purchase orders as of June 30, 2005. We believe that some of these obligations could be canceled for payment of a nominal penalty or no penalty; however, the amount of open purchase orders that could be canceled under such terms is difficult to quantify.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Item 7A. ***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 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 shorter duration securities. We have no outstanding debt nor do we utilize derivative financial instruments. Therefore, no quantitative tabular disclosures are required.

Item 8. ***Financial Statements and Supplementary Data***

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of
Qualstar Corporation

We have audited the accompanying consolidated balance sheets of Qualstar Corporation as of June 30, 2005 and 2004, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended June 30, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Qualstar Corporation at June 30, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended June 30, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

/s/ ERNST & YOUNG LLP

Woodland Hills, California
August 10, 2005

QUALSTAR CORPORATION

CONSOLIDATED BALANCE SHEETS
(In thousands)

	June 30, 2005	June 30, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$12,210	$ 6,401
Marketable securities	21,854	29,376
Accounts receivable, net of allowances of $248 at June 30, 2005 and $217 at June 30, 2004	3,532	4,628
Inventories	7,157	7,418
Prepaid expenses and other current assets	452	470
Prepaid income taxes	640	1,072
Deferred income taxes	—	594
Total current assets	45,845	49,959
Property and equipment, net	1,188	1,439
Other assets	190	249
Total assets	$47,223	$51,647
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 763	$ 1,171
Accrued payroll and related liabilities	496	500
Other accrued liabilities	1,311	1,754
Total current liabilities	2,570	3,425
Deferred income taxes	—	158
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 and 12,596 shares issued and outstanding as of June 30, 2005 and June 30, 2004, respectively	18,370	20,121
Notes from directors	—	(45)
Accumulated other comprehensive income (loss)	(159)	(101)
Retained earnings	26,442	28,089
Total shareholders' equity	44,653	48,064
Total liabilities and shareholders' equity	$47,223	$51,647

See accompanying notes

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Years Ended June 30,		
	2005	2004	2003
Net revenues	$25,144	$31,530	$33,557
Cost of goods sold	16,529	19,575	21,171
Gross profit	8,615	11,955	12,386
Operating expenses:			
Research and development	3,750	4,268	3,994
Sales and marketing	3,350	3,607	3,834
General and administrative	3,955	5,420	4,428
Total operating expenses	11,055	13,295	12,256
Income (loss) from operations	(2,440)	(1,340)	130
Investment income	858	624	693
Impairment loss for other-than-temporary decline in investments	—	(160)	—
Income (loss) before income taxes	(1,582)	(876)	823
Provision (benefit) for income taxes	65	(145)	274
Net income (loss)	$(1,647)	$ (731)	$ 549
Earnings (loss) per share:			
Basic	$ (0.13)	$ (0.06)	$ 0.04
Diluted	$ (0.13)	$ (0.06)	$ 0.04
Shares used to compute earnings (loss) per share:			
Basic	12,398	12,577	12,579
Diluted	12,398	12,577	12,666

See accompanying notes

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(In thousands)

	Common Stock Shares	Common Stock Amount	Deferred Compensation	Notes from Directors	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
Balances at July 1, 2002	12,656	20,751	(631)	(387)	(31)	28,271	47,973
Exercise of stock options	60	149	—	—	—	—	149
Forfeiture of unvested stock options	—	(190)	190	—	—	—	—
Retirement of shares pursuant to stock repurchase	(76)	(344)	—	—	—	—	(344)
Amortization of deferred compensation	—	—	301	—	—	—	301
Accrued interest on directors' notes	—	—	—	(17)	—	—	(17)
Principal payments on directors' notes	—	—	—	248	—	—	248
Comprehensive income:							
Net income	—	—	—	—	—	549	549
Change in unrealized gains (losses) on investments	—	—	—	—	9	—	9
Comprehensive income							558
Balances at June 30, 2003	12,640	$20,366	$(140)	$(156)	$ (22)	$28,820	$48,868
Exercise of stock options	19	69	—	—	—	—	69
Retirement of shares pursuant to stock repurchase	(63)	(314)	—	—	—	—	(314)
Amortization of deferred compensation	—	—	140	—	—	—	140
Accrued interest on directors' notes	—	—	—	(6)	—	—	(6)
Principal and interest payments on directors' notes	—	—	—	117	—	—	117
Comprehensive loss:							
Net loss	—	—	—	—	—	(731)	(731)
Change in unrealized gains (losses) on investments	—	—	—	—	(239)	—	(239)
Impairment loss for other-than-temporary decline in investments	—	—	—	—	160	—	160
Comprehensive loss							(810)
Balances at June 30, 2004	12,596	$20,121	$ —	$ (45)	$(101)	$28,089	$48,064
Exercise of stock options	16	76	—	—	—	—	76
Retirement of shares pursuant to stock repurchase	(359)	(1,827)	—	—	—	—	(1,827)
Principal and interest payments on directors' notes	—	—	—	45	—	—	45
Comprehensive loss:							
Net loss	—	—	—	—	—	(1,647)	(1,647)
Change in unrealized gains (losses) on investments	—	—	—	—	(58)	—	(58)
Comprehensive loss							(1,705)
Balances at June 30, 2005	12,253	$18,370	$ —	$ —	$(159)	$26,442	$44,653

See accompanying notes

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended June 30,		
	2005	2004	2003
OPERATING ACTIVITIES:			
Net income (loss)	$ (1,647)	$ (731)	$ 549
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	463	423	380
Deferred income taxes	436	312	657
Provision for (recovery of) bad debts and returns	38	186	(53)
Amortization of deferred compensation	—	140	301
Impairment loss for other-than-temporary decline in investments	—	160	—
Accrued interest on directors' notes	—	(6)	(17)
Gain on sale of securities	(11)	—	—
Changes in operating assets and liabilities:			
Accounts receivable	1,058	(279)	2,213
Inventories	261	(327)	2,609
Prepaid expenses and other assets	29	(222)	236
Prepaid income taxes and income taxes payable	432	264	(1,167)
Accounts payable	(408)	35	(454)
Accrued payroll and related liabilities	(4)	68	124
Other accrued liabilities	(443)	285	657
Net cash provided by operating activities	204	308	6,035
INVESTING ACTIVITIES:			
Purchases of equipment and leasehold improvements	(164)	(257)	(561)
Purchases of marketable securities	(22,277)	(41,123)	(34,375)
Proceeds from the sale of marketable securities	29,752	41,365	30,513
Purchase of assets of N2Power, Incorporated	—	—	(288)
Net cash provided by (used in) investing activities	7,311	(15)	(4,711)
FINANCING ACTIVITIES:			
Principal and interest payments on directors' notes	45	117	248
Proceeds from exercise of stock options	76	69	149
Repurchase of common stock	(1,827)	(314)	(344)
Net cash provided by (used in) financing activities	(1,706)	(128)	53
NET INCREASE IN CASH AND CASH EQUIVALENTS	5,809	165	1,377
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	6,401	6,236	4,859
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 12,210	$ 6,401	$ 6,236
SUPPLEMENTAL CASH FLOW DISCLOSURES:			
Income taxes paid	$ 5	$ 12	$ 904

See accompanying notes

QUALSTAR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Business

Qualstar Corporation (''Qualstar'') was incorporated in California in 1984 to develop and manufacture IBM compatible 9-track reel-to-reel tape drives for the personal computer and workstation marketplaces. Since 1995, Qualstar has focused its efforts on designing, developing, manufacturing and selling automated magnetic tape libraries used to store, retrieve and manage electronic data primarily in the network computing environment. Tape libraries consist of cartridge tape drives, tape cartridges and robotics to move the tape cartridges from their storage locations to the tape drives under software control. Qualstar's libraries provide storage solutions for organizations requiring backup, recovery, and archival storage of critical electronic information. Qualstar's tape libraries are compatible with commonly used operating systems, including UNIX, Windows and Linux and a wide range of storage management software. Qualstar offers tape libraries for multiple tape drive technologies, including those using LTO, AIT, Super AIT, and SuperDLT.

In July 2002, Qualstar purchased the assets of N2Power, Incorporated, a supplier of ultra small high efficiency open frame switching power supplies. Power supplies are sold with the N2Power brand name as well as under a private label brand name to original equipment manufacturers. In addition, they are utilized in Qualstar's tape library products.

Principles in Consolidation

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

Cash and Cash Equivalents

Qualstar classifies as cash equivalents only cash and those investments that are short term, highly liquid, readily convertible to cash, and so near their maturity that they present an insignificant risk of change in value due to changes in interest rates.

Concentration of Credit Risk, Other Risks and Significant Customers

Qualstar sells its products primarily through a variety of market channels including original equipment manufacturers (OEM) and value added resellers (VAR) located worldwide. Ongoing credit evaluations of customers' financial condition are performed by Qualstar, and generally, collateral is not required. Potential uncollectible accounts have been provided for in the financial statements.

Sales outside of North America represented approximately 27.3% of net revenues in fiscal 2005, approximately 32.4% of net revenues in fiscal 2004 and approximately 29.4% of net revenues in fiscal 2003. Revenues from Qualstar's two largest customers combined were approximately 13.9%, 14.6%, and 15.4% for the years ended June 30, 2005, 2004, and 2003, respectively. At June 30, 2005, 2004 and 2003, the two largest customer's accounts receivable, net of specific allowances, totaled approximately 18.7%, 22.4% and 30.1% of net accounts receivable, respectively.

Marketable Securities

Marketable securities consist primarily of high-quality U.S. corporate securities and U.S. federal government and state government debt securities. These securities are classified in one of three categories: trading, available-for-sale, or held-to-maturity. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity securities are those securities which Qualstar has the ability and intent to hold until maturity. All other securities not included in trading or held-to-maturity are classified as available-for-sale. All of Qualstar's marketable securities were classified as available-for-sale at June 30, 2005 and 2004.

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.

On March 31, 2004, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments", (EIFT 03-1) effective for annual financial statements with fiscal years ending after June 15, 2004. EITF 03-1 provides guidance for determining when an investment is other-than-temporarily impaired, and states that an investment is considered other-than-temporarily impaired when its fair value is less than its amortized cost basis and is deemed other than temporary. The application of EITF 03-1 to the Company's marketable securities portfolio resulted in the identification of an other-than-temporarily impaired investment as of June 30, 2004. In accordance with EITF 03-1, the Company recognized an impairment loss for other-than-temporary decline in investments of $160,000 in earnings equal to the difference between the amortized cost basis and its fair value as of June 30, 2004.

Inventories

Inventories are stated at the lower of cost (first-in, first-out basis) or market.

Suppliers

Sales and costs of goods sold related to products purchased from one supplier totaled approximately 47.8% and 41.0%, respectively, of total sales and cost of goods sold for the year ended June 30, 2005. Sales and costs of goods sold related to products purchased from one large supplier totaled approximately 51.1% and 41.3%, respectively, of total sales and cost of goods sold for the year ended June 30, 2004. Sales and costs of goods sold related to products purchased from one supplier totaled approximately 56.2% and 57.3%, respectively, of total sales and cost of goods sold for the year ended June 30, 2003.

Property and Equipment

Property and equipment is depreciated using the straight-line method over the estimated useful lives (3 to 7 years) of the individual assets. Leasehold improvements are amortized over the estimated useful lives, or the term of the related leases, whichever is shorter, using the straight-line method.

Long-Lived Assets

Qualstar reviews for the impairment of long-lived assets whenever events or changes in circumstances indicate the carrying amount of any asset may not be recoverable. An impairment loss would be recognized when the estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition is less than the carrying amount. If an impairment is indicated, the amount of the loss to be recorded is based upon an estimate of the difference between the carrying amount and the fair value of the asset. Fair value is based upon discounted cash flows expected to result from the use of the asset and its eventual disposition and other valuation methods. There were no impairment losses of long-lived assets recognized during the periods presented.

Revenue Recognition

Revenues are recognized upon shipment of the product to the customer and when collectibility is reasonably assured, less estimated returns for which provisions are made at the time of sale. The provision for estimated returns is made based on known claims and estimates of additional returns based on historical data. Revenues from technical support services and other services are recognized at the time the services are performed.

Shipping and Handling Costs

Qualstar generally records all charges for outbound shipping and handling as revenue. All inbound shipping and fulfillment costs are classified as costs of goods sold.

Warranty Obligations

Qualstar provides a three year warranty period on its tape libraries. Some TLS and all RLS models have three year advance replacement warranty coverage that provides for replacement of components, or if necessary, complete libraries. All other TLS models have a one year advance replacement warranty with the second and third year being return-to-factory for service at no charge. Customers may purchase extended advance replacement service coverage and on-site service if they are located in the United States, Canada and most countries within Europe. A provision for costs related to warranty expense is recorded when revenue is recognized, which is estimated based on historical warranty costs incurred.

In November 2002, the Financial Accounting Standards Board (FASB) issued 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 and 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. Qualstar adopted FIN 45 for the year ended June 30, 2003, and the adoption has had no impact on Qualstar's financial position or results of operations. Additional disclosures have not been provided as the Company's warranty accrual and warranty expense is not material in any of the periods presented.

Research and Development

All research and development costs are charged to expense as incurred. These costs consist primarily of engineering salaries, benefits, outside consultant fees, and purchased parts and supplies of personnel directly involved in the design and development of new products.

Advertising

Qualstar expenses all costs of advertising and promotion as incurred. Advertising and promotion expenses for the years ended June 30, 2005, 2004 and 2003 were approximately $520,000, $601,000, and $984,000, respectively.

Accounting for Stock Based Compensation

Employee stock options are accounted for under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," as amended and interpreted, which requires the recognition of expense when the option price is less than the fair value of the stock at the date of grant. Qualstar generally awards options for a fixed number of shares at an option price equal to the fair value at the date of grant.

Qualstar has adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS 123).

If Qualstar recognized employee stock option-related compensation expense in accordance with SFAS 123 and used the minimum value method for grants prior to the Company's initial public offering and the Black-Scholes method model afterward for determining the weighted average fair value of options granted, the Company's net income (loss) and earnings (loss) per share would have been reduced to the pro forma amounts indicated below:

	Fiscal Year Ended June 30,		
	2005	2004	2003
	(in thousands, except per share amounts)		
Net income (loss) as reported	$ (1,647)	$ (731)	$ 549
Stock-based employee compensation cost included in reported net income	—	140	301
Pro forma stock-based employee compensation cost under SFAS 123	(118)	(505)	(591)
Pro forma net income (loss)	$ (1,765)	$ (1,096)	$ 259
Earnings (loss) per share:			
Basic — as reported	$ (0.13)	$ (0.06)	$ 0.04
Basic — pro forma	$ (0.14)	$ (0.09)	$ 0.02
Diluted — as reported	$ (0.13)	$ (0.06)	$ 0.04
Diluted — pro forma	$ (0.14)	$ (0.09)	$ 0.02

For purposes of pro forma disclosures, the estimated fair value of the options is amortized over the options' vesting periods. The pro forma effect on net income or loss for 2005, 2004 and 2003 is not representative of the pro forma effect on net income or loss in future years because compensation expense in future years may reflect the amortization of a larger number of stock options granted in several succeeding years.

In computing the pro forma compensation expense under SFAS 123, a weighted-average fair value of $1.27 for 2005, $3.59 for 2004, and $4.29 for 2003 stock option grants was estimated at the date of grant using the minimum value option pricing model before Qualstar's initial public offering and the Black Scholes model afterward with the following assumptions:

	2005	2004	2003
Expected dividend yield	0%	0%	0%
Risk-free interest rate	3.8%	2.9%	2.7%
Expected life of options	4 years	4 years	5 years
Volatility	36.9%	100.8%	54.0%

Income Taxes

Income taxes are accounted for using the liability method in accordance with SFAS 109, "Accounting for Income Taxes." Under this method, deferred tax liabilities and assets are recognized for the expected future tax consequences of temporary differences between the financial statement and tax bases of assets and liabilities, and for the expected future tax benefit to be derived from tax credits and loss carryforwards. Current income tax expense or benefit represents the amount of income taxes expected to be payable or refundable for the current year. A valuation allowance is established when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Comprehensive Income (Loss)

Comprehensive income (loss) is accounted for according to SFAS No. 130, "Reporting Comprehensive Income" (SFAS 130). Comprehensive income (loss) includes unrealized gains and losses on debt and equity securities classified as available-for-sale and included as a component of shareholders' equity.

Earnings (Loss) Per Share

Qualstar calculates earnings (loss) per share in accordance with SFAS No. 128, "Earnings per Share." Basic earnings per share has been computed by dividing net income (loss) by the weighted average number of common shares outstanding. Diluted earnings (loss) per share has been computed by dividing net income (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 calculation for basic and diluted earnings per share for the periods indicated:

	Year Ended June 30,		
	2005	2004	2003
	(In thousands)		
Earnings:			
Net income (loss)	$(1,647)	$ (731)	$ 549
Shares:			
Weighted average shares for basic earnings (loss) per share	12,398	12,577	12,579
Stock options	—	—	87
Weighted average shares for diluted earnings (loss) per share	12,398	12,577	12,666

Shares issuable under stock options of 455,000, 511,000 and 152,000 for the years ended June 30, 2005, 2004 and 2003, respectively, have been excluded from the computation of diluted earnings (loss) per share because the effect would be antidilutive.

Segment Information

Based on the provisions of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" and the manner in which the Chief Operating Decision Maker analyzes the business, Qualstar has determined that it does not have separately reportable operating segments.

Fair Value of Financial Instruments

The carrying amounts reported in the balance sheets for cash and cash equivalents, accounts receivable and accounts payable approximate their fair values due to the short term nature of these financial instruments.

Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates. Management believes that the estimates are reasonable.

Reclassification

Certain prior year amounts have been reclassified to conform to the current year presentation.

2. Marketable Securities

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 June 30, 2005.

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
			(In thousands)			
US Treasury obligations and direct obligations of U.S. Government agencies	$3,973	$(27)	$ 8,645	$(58)	$12,618	$ (85)
Government Sponsored Enterprise collateralized mortgage obligations	934	(3)	1,538	(17)	2,472	(20)
Corporate bonds	4,054	(41)	1,708	(13)	5,762	(54)
Total	$8,961	$(71)	$11,891	$(88)	$20,852	$(159)

U.S. Treasury Obligations. The unrealized losses on the Company's investments in U.S. Treasury obligations and direct obligations of U.S. Government agencies were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2005.

Government Sponsored Enterprise (GSE) Collateralized Mortgage Obligations. Freddie Mac and Fannie Mae are identified as GSEs. The unrealized losses on the Company's investment in GSE collateralized mortgage obligations were caused by interest rate increases. The cash flows of these investments are guaranteed by the GSE. Because the decline in market value is attributable to changes in interest rates and not credit quality and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2005.

Corporate Bonds. The unrealized losses on the Company's investments in corporate bonds were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2005.

3. Inventories

Inventories consist of the following:

	June 30, 2005	June 30, 2004
	(in thousands)	
Raw materials	$6,196	$6,370
Finished goods	961	1,048
	$7,157	$7,418

4. Property and Equipment

The components of property and equipment are as follows:

	June 30, 2005	June 30, 2004
	(in thousands)	
Leasehold improvements	$ 546	$ 546
Furniture and fixtures	994	970
Machinery and equipment	2,320	2,340
	3,860	3,856
Less accumulated depreciation and amortization	(2,672)	(2,417)
	$ 1,188	$ 1,439

5. Income Taxes

The provision (benefit) for income taxes is comprised of the following:

	Year Ended June 30, 2005	2004	2003
	(in thousands)		
Current:			
Federal	$(156)	$(451)	$(332)
State	(215)	(6)	(51)
	(371)	(457)	(383)
Deferred:			
Federal	342	257	579
State	94	55	78
	436	312	657
	$ 65	$(145)	$ 274

The following is a reconciliation of the statutory federal income tax rate to Qualstar's effective income tax rate:

	Year Ended June 30,		
	2005	2004	2003
Statutory federal income tax expense (benefit)	(34.0)%	(34.0)%	34.0%
State income taxes, net of federal income tax benefit	(3.7)	(4.2)	2.6
Non-taxable investment income	(3.4)	(16.0)	(16.6)
Research and development credits	(15.5)	(22.8)	—
Valuation allowance	60.9	55.2	—
Amortization of deferred compensation	0.0	5.4	12.5
Other	(0.2)	(0.2)	0.8
	4.1%	(16.6)%	33.3%

The tax effect of temporary differences resulted in deferred income tax assets (liabilities) as follows:

	June 30,	
	2005	2004
	(in thousands)	
Deferred tax assets:		
Net operating loss carryforwards	$ 610	$ 26
Capital loss and other credit carryforwards	501	513
Research and development credit carryforwards	471	503
Allowance for bad debts and returns	102	89
Inventory reserves	167	146
Capitalized inventory costs	40	33
Other accruals	331	326
Total gross deferred tax assets	2,222	1,636
Deferred tax liabilities:		
Depreciation and other	(215)	(158)
Total gross deferred tax liabilities	(215)	(158)
Valuation allowance	(2,007)	(1,042)
Net deferred tax assets	$ —	$ 436

The Company placed a valuation allowance on net deferred tax assets during the fiscal year ended June 30, 2005 based on the Company's assessment regarding the realizability of such assets in future years. The Company has net operating losses, capital losses, research and development credit and other carryforwards for tax purposes of $1,582 at June 30, 2005 expiring between fiscal years 2009 and 2025, except for the state research and development credit, which has no limit on the carryforward period.

The Company had fiscal 2002 under audit by the Internal Revenue Service ("IRS") for which the IRS issued a no change opinion in the quarter ended March 31, 2005.

6. Preferred Stock

Qualstar's capital structure allows for the Board of Directors to authorize 5,000,000 shares of preferred stock. The Board of Directors has authority to fix the rights, preferences, privileges and restrictions, including voting rights, of these shares of preferred stock without any future vote or action by the shareholders. At June 30, 2005 and 2004, there were no outstanding shares of preferred stock.

7. Stock Option Plans

Qualstar adopted a stock option plan (1998 Stock Incentive Plan) under which incentive and nonqualified stock options could be granted for an aggregate of no more than 1,215,000 shares of common stock. Under the terms of the plan, options could be issued at an exercise price of not less than 100% of the fair market value of common stock as determined by the board of directors (or board appointed administrator) on the date of grant. If an incentive stock option is granted to an individual owning more than 10% of the total combined voting power of all stock, the exercise price of the option may not be less than 110% of the fair market value of the underlying shares on the date of grant. Options are exercisable in annual installments and terminate as specified in each option agreement, but terminate no later than ten years after the date of grant.

The following table summarizes all stock option activity:

	Stock Options	Exercise Price per Share	Weighted Average Exercise Price
	(in thousands, except per share amounts)		
Outstanding at June 30, 2003	480	$2.78 - $9.38	$5.27
Granted	104	5.10	5.10
Exercised	(19)	2.78 - 5.25	3.54
Cancelled	(54)	4.89 - 9.38	5.90
Outstanding at June 30, 2004	511	$4.23 - $9.38	$5.24
Granted	90	3.71	3.71
Exercised	(16)	4.23 - 5.25	4.74
Cancelled	(130)	4.23 - 9.38	5.79
Outstanding at June 30, 2005	455	$3.71 - $9.38	$4.80

	Options Outstanding at June 30, 2005			Options Exercisable at June 30, 2005	
Exercise Price Range	Number of Shares Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Shares Exercisable	Weighted Average Exercise Price
$3.71	90	10.0	$3.71	—	$ —
$4.23 - 5.94	333	7.2	$4.65	181	$4.63
$9.38	32	5.1	$9.38	32	$9.38

On January 14, 2000, each of Qualstar's four non-employee directors were granted and purchased 54,000 shares of restricted stock pursuant to the 1998 Stock Incentive Plan at a price of $2.78 per share. Each director paid for the shares with a promissory note in the amount of $150,000 secured by the purchased shares. Interest on the notes accrued at the rate of 6.21% and was payable annually. Payments of principal on the notes were due in four equal annual installments beginning in January 2002. Qualstar, solely at its discretion, had the right to repurchase each director's restricted shares at the original purchase price upon termination of service for any reason. Qualstar's repurchase right lapsed and the shares vested ratably over four years based upon each year of service as a director. All of these shares were fully vested as of January 14, 2004.

Upon issuance of the restricted stock and granting of stock options in January 2000, Qualstar recorded a deferred compensation charge of $1.7 million related to both stock options and restricted stock for the difference between the exercise price and the deemed fair market value for accounting purposes on the date of the grant. The deferred compensation recorded was amortized over a four-year vesting period, which resulted in compensation expense of $140,000 in fiscal 2004, $301,000 in fiscal 2003, and $430,000 in fiscal 2002. During the year ended June 30, 2003, approximately 52,000 of unvested stock options related to these grants were forfeited. The forfeitures resulted in a decrease in common stock paid-in-capital and deferred compensation of $190,000 during the year ended June 30, 2003.

8. Purchase of N2Power

On July 11, 2002, Qualstar acquired the assets and intellectual properties of N2Power, Incorporated, a privately held company which designed and produced small and efficient open-frame switching power supplies. The consideration for this acquisition amounted to $250,000 plus acquisition expenses of $38,000. The purchase price was primarily allocated to a patent, in the amount of $240,000, which is being amortized over 5 years. At June 30, 2005, accumulated amortization of the patent was $144,000. Amortization expense for the years ended June 30, 2005, 2004 and 2003 was $48,000 in each year. Amortization expense is estimated to be $48,000 in each of the fiscal years 2006 and 2007.

9. Commitments

Qualstar's lease agreement for its facility located in Simi Valley, California, expires in February of 2011, with an early termination option becoming available in February of 2007. The annual rent for the lease is $468,000, with step-ups ranging from $28,000 to $34,000 every two years.

Qualstar's lease agreement for its facility located in Boulder, Colorado, expires in May of 2007. The annual rent for the lease is $55,000, with a nominal step-up of approximately 2% annually.

Future minimum lease payments under these leases are as follows:

Year Ending	Minimum Lease Payment
2006	$ 581,000
2007	592,000
2008	554,000
2009	570,000
Thereafter	895,000
	$3,192,000

Rent expense (including equipment rental) for the years ended June 30, 2005, 2004, and 2003, was $671,000, $679,000, and $589,000, respectively.

10. Legal Proceedings

On January 10, 2003, Raytheon Company ("Raytheon") filed a complaint in the United States District Court for the Eastern District of Texas alleging that Qualstar and eight other named defendants infringed on a patent owned by Raytheon entitled "Mass Data Storage Library." Raytheon filed an amended complaint on or about February 6, 2003, which included an allegation that Qualstar's tape libraries infringe Raytheon's patent. On April 2, 2004, Raytheon and Qualstar entered into a written settlement agreement pursuant to which all claims between the parties alleged in the litigation were dismissed with prejudice. The costs to settle this dispute have been included in our results of operations in general and administrative expenses in the year ended June 30, 2004 and have not had a material adverse effect on our financial position.

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. We cannot assure you that we will not be adversely affected in the future by legal proceedings.

11. Geographic Information

Information regarding revenues attributable to the Qualstar's primary geographic operating regions is as follows:

	Year Ended June 30,		
	2005	2004	2003
		(in thousands)	
Revenues:			
North America	$18,281	$21,312	$23,678
Europe	4,933	4,842	7,349
Asia	1,264	4,279	1,837
Other	666	1,097	693
	$25,144	$31,530	$33,557

The geographic classification of revenues is based upon the location to which the product is shipped. Qualstar does not have any significant long-lived assets outside of the United States.

12. Benefit Plans

Qualstar has a voluntary deferred compensation plan (the Plan) qualifying for treatment under Internal Revenue Code Section 401(k). All employees are eligible to participate in the Plan following three months of service of employment and may contribute up to 100% of their compensation on a pre-tax basis, not to exceed the annual IRS maximum. Qualstar, at the discretion of management, may make matching contributions in an amount equal to 25% of the first 6% of compensation contributed by eligible participants. Qualstar's contributions under the Plan totaled $67,000, $76,000, and $58,000 for the years ended June 30, 2005, 2004, and 2003 respectively.

13. Related Party Transactions

Qualstar's outside counsel is a member of its board of directors. During the years ended June 30, 2005, 2004, and 2003 Qualstar paid $105,000, $131,000, and $149,000, respectively to the law firm in which the director is a shareholder for general business purposes.

14. Recent Accounting Pronouncements

On December 16, 2004, the FASB issued FASB Statement No. 123 (revised 2004), Share-Based Payment (SFAS 123(R), which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation. SFAS 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

SFAS 123(R) must be adopted as of the first interim or annual reporting period that begins after June 15, 2005. We will adopt SFAS 123(R) on July 1, 2005.

SFAS 123(R) permits public companies to adopt its requirements using one of two methods. The first method is a modified prospective transition method whereby a company would recognize share-based employee costs from the beginning of the fiscal period in which the recognition provisions are first applied as if the fair-value-based accounting method had been used to account for all employee awards granted, modified, or settled after the effective date and to any awards that were not fully vested as of the effective date. Measurement and attribution of compensation cost for awards that are nonvested as of the effective date of SFAS 123(R) would be based on the same estimate of the grant-date fair value and the same attribution method used previously under SFAS 123. For those awards that are granted, modified, or settled after Statement 123(R) is adopted, compensation cost will be measured and recognized in the financial statements in accordance with the provisions of Statement 123(R). Prior periods would not be restated.

The second adoption method is a modified retrospective transition method whereby a company would recognize employee compensation cost for periods presented prior to the adoption of SFAS 123(R) in accordance with the original provisions of SFAS 123; that is, an entity would recognize employee compensation cost in the amounts reported in the pro forma disclosures provided in accordance with SFAS 123. A company would not be permitted to make any changes to those amounts upon adoption of SFAS 123(R) unless those changes represent a correction of an error. For periods after the date of adoption of SFAS 123(R), the modified prospective transition method described above would be applied.

The Company currently expects to adopt SFAS 123(R) using the modified prospective transition method, and expects the adoption to have an effect on Qualstar's results of operations similar to the amounts reported historically in the Company's footnotes under the pro forma disclosure provisions of SFAS 123.

15. Quarterly Results of Operations (Unaudited)

	Three Months Ended			
	June 30,	March 31,	December 31,	September 30,
	(In thousands, except per share amounts)			
Fiscal 2005:				
Net sales	$6,706	$5,742	$6,392	$6,305
Gross profit	2,110	1,861	2,311	2,333
Net income (loss)	(429)	(635)	(347)	(236)
Net earnings (loss) per share:				
Basic	$(0.04)	$(0.05)	$(0.03)	$(0.02)
Diluted	(0.04)	(0.05)	(0.03)	(0.02)
Fiscal 2004:				
Net sales	$7,696	$8,302	$9,556	$5,976
Gross profit	3,114	3,007	3,594	2,240
Net income (loss)	(16)	(346)	207	(576)
Net earnings (loss) per share:				
Basic	$ 0.00	$(0.03)	$ 0.02	$(0.05)
Diluted	0.00	(0.03)	0.02	(0.05)

SCHEDULE II

QUALSTAR CORPORATION

VALUATION AND QUALIFYING ACCOUNTS
ALLOWANCE FOR DOUBTFUL ACCOUNTS
For the Years Ended June 30, 2005, 2004, and 2003

Column A	Column B	Column C		Column D	Column E
Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Deductions(1)	Balance at End of Period
Year Ended June 30, 2005	$ 217,000	$172,000	$—	$ 141,000	$248,000
Year Ended June 30, 2004	$ 260,000	$208,000	$—	$ 251,000	$217,000
Year Ended June 30, 2003	$2,100,000	$(53,000)	$—	$1,787,000	$260,000

(1) Uncollectible accounts written off, net of recoveries.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

Item 9A. ***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 June 30, 2005, 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 fourth quarter of fiscal 2005 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. ***Other Information***

None.

PART III

The information called for by Items 10, 11, 12, 13 and 14 of Part III of Form 10-K (except information as to Qualstar's executive officers, which is included under Part I, Item 1 of this Report) will be included in Qualstar's Proxy Statement which management intends to file with the Securities and Exchange Commission within 120 days after the close of its fiscal year ended June 30, 2005, and is hereby incorporated by reference to such Proxy Statement.

Item 10. ***Directors and Executive Officers of the Registrant***

A list of our executive officers and biographical information appears in Part I, Item 1 of this report. Information about our Directors may be found under the caption "Election of Directors" of our Proxy Statement (the "Proxy Statement"). That information is incorporated herein by reference.

The information in the Proxy Statement set forth under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" is incorporated herein by reference.

Item 11. ***Executive Compensation***

The information in the Proxy Statement set forth under the captions "Executive Compensation" and "Information Regarding the Board and its Committees" is incorporated herein by reference.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management***

The information in the Proxy Statement set forth under the caption "Security Ownership of Certain Beneficial Owners and Management" is incorporated herein by reference.

Item 13. ***Certain Relationships and Related Transactions***

The information set forth under the captions "Certain Relationships and Related Transactions" of the Proxy Statement is incorporated herein by reference.

Item 14. *Principal Accountant Fees and Services*

Information concerning principal accountant fees and services appears in the Proxy Statement "Independent Registered Public Accounting Firm" and is incorporated herein by reference.

PART IV

Item 15. *Financial Statement Schedules and Exhibits*

(a) The financial statements and supplemental schedules are set forth under Item 8 of this Annual Report on Form 10-K.

All other schedules have been omitted since the required information is not present in amounts sufficient to require submission of the schedule, or because the required information is included in the consolidated financial statements or notes thereto.

(b) *Exhibits:*

Exhibit No.	Description
3.1(1)	Restated Articles of Incorporation.
3.2(1)	Amended and Restated Bylaws.
10.1(1)*	1998 Stock Incentive Plan, as amended and restated.
10.2(1)	Form of Indemnification Agreement.
10.3(2)	Lease agreement between Strategic Performance Fund-II, Inc. and Qualstar Corporation, dated September 20, 2000.
10.4*	Base salaries payable to executive officers during the fiscal year ending June 30, 2006.
10.5*	Cash bonus plan for executive officers for fiscal year ending June 30, 2006.
14.1(3)	Code of Business Conduct and Ethics
21.1	Subsidiaries of Qualstar Corporation
23.1	Consent of Independent Registered Public Accounting Firm.
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.

(1) Incorporated by reference to the designated exhibits to Qualstar's registration statement on Form S-1 (Commission File No. 333-96009), declared effective by the Commission on June 22, 2000.

(2) Incorporated by reference to the designated exhibit to Qualstar's Report on Form 10-Q for the fiscal quarter ended September 30, 2000.

(3) Incorporated by reference to the designated exhibit to Qualstar's Report on Form 10-K for the fiscal year ended June 30, 2004

* Each of these exhibits constitutes a management contract, compensatory plan or arrangement required to be filed as an exhibit to this report pursuant to Item 15(b) of this report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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

Date: September 26, 2005

By: /s/ WILLIAM J. GERVAIS

William J. Gervais,
Chief Executive Officer and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ WILLIAM J. GERVAIS William J. Gervais	Chief Executive Officer, President and Director (principal executive officer)	September 26, 2005
/s/ RICHARD A. NELSON Richard A. Nelson	Vice President, Engineering Secretary and Director	September 26, 2005
/s/ FREDERIC T. BOYER Frederic T. Boyer	Vice President and Chief Financial Officer (principal financial and accounting officer)	September 26, 2005
/s/ CARL W. GROMADA Carl W. Gromada	Director	September 26, 2005
/s/ JOSE M. MIYAR Jose M. Miyar	Director	September 26, 2005
/s/ ROBERT E. RICH Robert E. Rich	Director	September 26, 2005
/s/ ROBERT T. WEBBER Robert T. Webber	Director	September 26, 2005

EXHIBIT INDEX

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* Each of these exhibits constitutes a management contract, compensatory plan or arrangement required to be filed as an exhibit to this report pursuant to Item 15(b) of this report.

EXHIBIT 10.4

Base Salaries
For Executive Officers of
Qualstar Corporation
For the Fiscal Year Ending June 30, 2006

Name	Title	Fiscal Year 2006 Base Salary[1]
William J. Gervais	Chief Executive Officer and President	$ 185,000
Frederic T. Boyer	Vice President and Chief Financial Officer	$ 175,000
Robert K. Covey	Vice President of Marketing	$ 167,000
David L. Griffith	Vice President of Operations	$ 165,000
Robert C. King	Vice President of Sales	$ 160,000[2]
Richard A. Nelson	Vice President of Engineering	$ 146,000

(1) Qualstar is an "at will" employer. The expression of base salaries in annual amounts does not imply that there is an agreement to employ any executive officer for any specific period of time.

(2) Mr. King also receives an auto allowance of $6,000 per year.

EXHIBIT 10.5

Cash Bonus Plan for
Executive Officers of
Qualstar Corporation
For the Fiscal Year Ending June 30, 2006

Executive Officers of Qualstar Corporation are entitled to receive cash bonuses if the Company achieves stated levels of consolidated revenue and pre-tax profits for the fiscal year ending June 30, 2006, excluding the effects of acquisitions, if any, made during the fiscal year. The Company's Board of Directors reserves the right to modify this bonus plan from time to time, if appropriate, in the event of extraordinary circumstances.

For all executive officers other than the Vice President of Sales, the potential cash bonuses will be as follows: (1) from 0% of base salary if consolidated revenue is less than $25 million for the fiscal year ending June 30, 2006, to a maximum of 20% of base salary if consolidated revenue is more than $50 million for the fiscal year ending June 30, 2006; plus (2) an additional bonus ranging from 0% of base salary if the Company is not profitable for the fiscal year ending June 30, 2006, to a maximum of 20% of base salary if consolidated pre-tax profits are more than 19% of consolidated revenue for the fiscal year ending June 30, 2006. Bonuses will be paid during the first fiscal quarter following completion of the fiscal year based on the actual revenue and pre-tax profit levels achieved for that year and provided that the executive is still employed by the Company as of the date of payment.

For the Vice President of Sales, the potential cash bonuses will be as follows: (1) from $3,000 if consolidated revenue, excluding revenue from sales of power supplies, is $21 million, to a maximum of $100,000 if consolidated revenue, excluding revenue from sales of power supplies, is more than $39 million; plus (2) an additional bonus ranging from 0% of base salary if consolidated pre-tax profits, including profits from sales of power supplies, are less than 5% of consolidated revenue for the fiscal year ending June 30, 2006, to a maximum of 15% of base salary if consolidated pre-tax profits, including profits from sales of power supplies, are more than 19% of consolidated revenue for the fiscal year ending June 30, 2006. His bonus will be computed quarterly based on an estimate of full year revenues and pre-tax profits and paid during the following quarter provided that he is still employed by the Company as of the date of payment. After completion of the fiscal year, his bonus will be calculated based on the actual revenue and pre-tax profit levels achieved for that year, and any adjustments to the estimated bonus payments will be made at that time.

Exhibit 21.1

SUBSIDIARIES OF QUALSTAR CORPORATION

Name	State of Incorporation
Qualstar Sales and Service Corporation	California

Exhibit 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM.

We consent to the incorporation by reference in the Registration Statement (Form S-8 No. 333-61080) pertaining to the Qualstar Corporation 1998 Employee Stock Incentive Plan of our report dated August 10, 2005, with respect to the consolidated financial statements and schedule of Qualstar Corporation included in the Annual Report (Form 10-K) for the year ended June 30, 2005.

September 26, 2005
Woodland Hills, CA

/s/ Ernst & Young LLP

Exhibit 31.1

SECTION 302 CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER

I, William J. Gervais, certify that:

1. I have reviewed this annual report on Form 10-K of Qualstar Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) [Paragraph (b) is omitted pursuant to SEC Release Nos. 33-8238 and 34-47986]

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 26, 2005

/s/ WILLIAM J. GERVAIS

William J. Gervais,
Chief Executive Officer

Exhibit 31.2

SECTION 302 CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER

I, Frederic T. Boyer, certify that:

1. I have reviewed this annual report on Form 10-K of Qualstar Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) [Paragraph (b) is omitted pursuant to SEC Release Nos. 33-8238 and 34-47986]

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 26, 2005

/s/ FREDERIC T. BOYER

Frederic T. Boyer,
Chief Financial Officer

Exhibit 32.1

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, William J. Gervais, Chief Executive Officer of Qualstar Corporation (the "Company"), certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, that:

(1) the Annual Report on Form 10-K of the Company for the fiscal year ended June 30, 2005 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 780(d)); and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: September 26, 2005

/s/ WILLIAM J. GERVAIS

William J. Gervais,
Chief Executive Officer

Exhibit 32.2

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Frederic T. Boyer, Chief Financial Officer of Qualstar Corporation (the "Company"), certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, that:

(1) the Annual Report on Form 10-K of the Company for the fiscal year ended June 30, 2005 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 780(d)); and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: September 26, 2005

/s/ Frederic T. Boyer

Frederic T. Boyer,
Chief Financial Officer