QUALSTAR CORP
Form 10-Q
February 13, 2006

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended December 31, 2005

o **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

Incorporated under the laws of the State of California	**95-3927330** *(I.R.S. Employer Identification No.)*

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

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

Total shares of common stock without par value outstanding at December 31, 2005 is 12,253,117.

Qualstar Corporation

FORM 10-Q

For The Quarterly Period Ended December 31, 2005

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PART I FINANCIAL INFORMATION

ITEM 1. *Financial Statements*

QUALSTAR CORPORATION

CONSOLIDATED CONDENSED BALANCE SHEETS DECEMBER 31, 2005 AND JUNE 30, 2005

	December 31, 2005 (Unaudited)	June 30, 2005 (Audited)
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,352	$ 12,210
Marketable securities	25,424	21,854
Receivables, net of allowances of $193 as of December 31, 2005, and $248 at June 30, 2005, respectively	3,047	3,532
Inventories	7,309	7,157
Prepaid expenses and other current assets	674	452
Prepaid income taxes	642	640
Total current assets	45,448	45,845
Property and equipment, net	1,083	1,188
Other assets	300	190
Total assets	$ 46,831	$ 47,223
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 867	$ 763
Accrued payroll and related liabilities	458	496
Other accrued liabilities	1,363	1,311
Total current liabilities	2,688	2,570
Shareholders equity:		
Common stock, no par value; 50,000 shares authorized, 12,253 shares issued and outstanding as of December 31, 2005 and June 30, 2005	18,442	18,370
Accumulated other comprehensive loss	(341)	(159)
Retained earnings	26,042	26,442

Total shareholders equity		44,143		44,653
Total liabilities and shareholders equity	$	46,831	$	47,223

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

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QUALSTAR CORPORATION

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
THREE MONTHS AND SIX MONTHS ENDED DECEMBER 31, 2005 AND 2004

	Three Months Ended December 31,		Six Months Ended December 31,	
	2005	2004	2005	2004
	(Unaudited) (In thousands, except per share data)			
Net revenues	$ 5,689	$ 6,392	$ 11,791	$ 12,697
Cost of goods sold	3,767	4,081	7,965	8,053
Gross profit	1,922	2,311	3,826	4,644
Operating expenses:				
Research and development	762	865	1,481	1,819
Sales and marketing	715	868	1,472	1,715
General and administrative	900	1,136	1,810	2,068
Total operating expenses	2,377	2,869	4,763	5,602
Loss from operations	(455)	(558)	(937)	(958)
Investment income	266	211	537	375
Loss before income taxes	(189)	(347)	(400)	(583)
Provision for income taxes				
Net loss	$ (189)	$ (347)	$ (400)	$ (583)
Loss per share:				
Basic	$ (0.02)	$ (0.03)	$ (0.03)	$ (0.05)
Diluted	$ (0.02)	$ (0.03)	$ (0.03)	$ (0.05)
Shares used to compute loss per share:				
Basic	12,253	12,477	12,253	12,541
Diluted	12,253	12,477	12,253	12,541

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

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QUALSTAR CORPORATION

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED DECEMBER 31, 2005 AND 2004

	Six Months Ended December 31,	
	2005	**2004**
	(Unaudited)	
	(In thousands)	
OPERATING ACTIVITIES:		
Net loss	$ (400)	$ (583)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Stock based compensation	72	
Depreciation and amortization	231	231
Provision for (recovery of) bad debts and returns	(22)	(2)
Changes in operating assets and liabilities:		
Accounts receivable	507	1,062
Inventories	(152)	(304)
Prepaid and other assets	(356)	(124)
Prepaid income taxes	(2)	301
Accounts payable	104	(242)
Accrued payroll and related liabilities	(38)	(11)
Other accrued liabilities	52	(193)
Net cash provided by operating activities	(4)	135
INVESTING ACTIVITIES:		
Purchases of property, equipment and leasehold improvements	(102)	(111)
Proceeds from sale of marketable securities	1,968	9,476
Purchases of marketable securities	(5,720)	(11,655)
Net cash used in investing activities	(3,854)	(2,290)
FINANCING ACTIVITIES:		
Proceeds from exercise of stock options		76
Repurchase of common stock		(1,827)
Principal and interest payments on directors notes		45
Net cash used in financing activities		(1,706)
Net decrease in cash	(3,858)	(3,861)
Cash and cash equivalents at beginning of period	12,210	6,401
Cash and cash equivalents at end of period	$ 8,352	$ 2,540

Supplemental cash flow disclosure:

Income taxes paid	$	$

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

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QUALSTAR CORPORATION

CONSOLIDATED CONDENSED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY
SIX MONTHS ENDED DECEMBER 31, 2005

	Common Stock Shares	Common Stock Amount	Accumulated Other Comprehensive Loss	Retained Earnings	Total
			(Unaudited) (In thousands)		
Balance at July 1, 2005	12,253	$ 18,370	$ (159)	$ 26,442	$ 44,653
Stock based compensation		72			72
Change in unrealized losses on investments			(182)		(182)
Net loss				(400)	(400)
Comprehensive loss					(582)
Balance at December 31, 2005	12,253	$ 18,442	$ (341)	$ 26,042	$ 44,143

See the accompanying notes to these condensed consolidated financial statements.

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QUALSTAR CORPORATION

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
DECEMBER 31, 2005
(Unaudited)
(In thousands, except per share data)

NOTE 1. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements are unaudited, except for the balance sheet at June 30, 2005 which is derived from our audited financial statements, and should be read in conjunction with the consolidated financial statements and related notes included in Qualstar Corporation s (Qualstar, us, we, or our) Annual Report Form 10-K for the fiscal year ended June 30, 2005, filed with the Securities and Exchange Commission (SEC) on September 26**,** 2005. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting primarily of normal recurring items, which are necessary for the fair presentation of Qualstar s consolidated financial position as of December 31, 2005, consolidated results of operations for the three and six months ended December 31, 2005, and consolidated cash flows for the six months ended December 31, 2005. Operating results for the three and six month periods ended December 31, 2005 are not necessarily indicative of results to be expected for a full year.

NOTE 2. LOSS PER SHARE

The following table sets forth the computation of basic and diluted net loss per share for the three and six months ended December 31, 2005 and 2004:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2005	**2004**	**2005**	**2004**
Numerator:				
Net loss	$ (189)	$ (347)	$ (400)	$ (583)
Denominator:				
Denominator for basic net loss per share weighted average shares	12,253	12,477	12,253	12,541
Dilutive potential common shares from employee stock options and restricted stock				
Denominator for diluted net loss per share adjusted weighted average shares and assumed conversions	12,253	12,477	12,253	12,541
Basic net loss per share	$ (0.02)	$ (0.03)	$ (0.03)	$ (0.05)
Diluted net loss per share	$ (0.02)	$ (0.03)	$ (0.03)	$ (0.05)

All shares related to stock options are excluded for the three months and six months ended December 31, 2005, and 2004, respectively, from the computation of diluted loss per share as the effect would have been antidilutive.

NOTE 3. STOCK BASED COMPENSATION

Effective July 1, 2005, we adopted Statement of Financial Accounting Standard (SFAS) No. 123(R), share- based payment, using the modified prospective application transition method. The adoption of SFAS No. 123(R) did not have a significant impact on our loss from operations, loss before income taxes, net loss, cash flows from operations, cash flows from financing activities, or our basic and diluted earnings per share, and the amounts recognized as stock based compensation expense are similar to the amounts reported historically in the Company s footnotes under the pro forma disclosure provisions of SFAS 123. Our net loss for the three months and six months ended December 31, 2005 includes $37,000 and $72,000, respectively, of compensation costs from options issued

QUALSTAR CORPORATION

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

prior to July 1, 2005. No stock options have been issued and none have been exercised subsequent to the adoption of SFAS 123(R).

For the three months and six months ended December 31, 2004, the Company 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 loss and loss per share for the three months and six months ended December 31, 2004 would have been reduced to the pro forma amounts indicated below:

	Three Months Ended December 31, 2004		Six Months Ended December 31, 2004	
Net loss as reported	$	(347)	$	(583)
Stock-based employee compensation cost included in reported net loss				
Pro forma stock-based employee compensation cost under SFAS 123		(68)		(136)
Pro forma net loss	$	(415)	$	(719)
Loss per share:				
Basic as reported	$	(0.03)	$	(0.05)
Basic pro forma	$	(0.03)	$	(0.06)
Diluted as reported	$	(0.03)	$	(0.05)
Diluted pro forma	$	(0.03)	$	(0.06)
Basic Weighted Average Shares		12,477		12,541
Diluted Weighted Average Shares		12,477		12,541

NOTE 4. MARKETABLE SECURITIES

Marketable securities consist primarily of high-quality U.S. corporate securities and U.S. federal government and state government debt securities. These securities are classified in one of three categories: trading, available-for-sale, or held-to-maturity. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity securities are those securities which Qualstar has the ability and intent to hold until maturity. All other securities not included in trading or held-to-maturity are classified as available-for-sale. All of Qualstar s marketable securities were classified as available-for-sale at December 31, 2005 and June 30, 2005.

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.

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QUALSTAR CORPORATION

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

NOTE 5. INVENTORIES

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

	December 31, 2005	June 30, 2005
Raw materials	$ 6,462	$ 6,196
Finished goods	847	961
	$ 7,309	$ 7,157

NOTE 6. COMPREHENSIVE LOSS

For the six months ended December 31, 2005 and 2004, comprehensive loss amounted to approximately $582,000 and $646,000, respectively. The difference between net loss and comprehensive loss relates to the changes in the unrealized losses or gains the Company recorded for its available-for-sale securities.

NOTE 7. LEGAL PROCEEDINGS

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

NOTE 8. INCOME TAXES

The Company has a full valuation allowance against it s net deferred tax assets due to the uncertainty regarding the realization of these net deferred tax assets in future periods.

ITEM 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Statements in this Quarterly Report on Form 10-Q concerning the future business, operating results and financial condition of Qualstar are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements inherently are subject to risks and uncertainties, some of which we cannot predict or quantify. Our actual results may differ materially from the results projected in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2005 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, expects, intends, estimates, anticipates, plans, seeks or the negative thereof or variations thereon or similar terminology. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements to reflect the occurrence of events or circumstances in the future.

OVERVIEW

We design, develop, manufacture and sell automated magnetic tape libraries used to store, retrieve and manage electronic data primarily in network computing environments. We offer tape libraries for multiple tape drive technologies including AIT, Super AIT, SuperDLT, and LTO tape drives and media.

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

We also design, develop, outsource manufacturing, and sell a line of ultra small high efficiency open-frame switching power supplies. We entered the power supply business in July 2002, when we purchased the assets of N2Power, Incorporated. These power supplies are utilized within our own tape library products as well as sold to original equipment manufacturers for incorporation into their products. We sell these power supplies under the N2Power brand name, as well as under a private label brand name, through independent sales representatives and distributors. Revenues from our N2Power products were not material as a percentage of total revenues for fiscal 2005 and fiscal 2004, but represented 9.9% of revenues in the second quarter and 9.4% of revenues in the first six months of fiscal 2006.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to customer promotional offers, sales returns, bad debts, inventories, warranty costs, investments, 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

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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 or power supplies 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 full valuation allowance against our net deferred tax assets due to the uncertainty surrounding the realization of these net deferred tax assets in future years. We have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for such a valuation allowance. In the event we were to determine that we would be able to realize all or part of our net deferred tax asset in the future, the valuation allowance would be decreased accordingly.

We may periodically undergo examinations by the federal and state regulatory authorities and the Internal Revenue Service. We may be assessed additional taxes and or penalties contingent on the outcome of these examinations. Our previous examinations have not resulted in any unfavorable or significant assessments.

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RESULTS OF OPERATIONS

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2005	2004	2005	2004
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	66.2	63.8	67.6	63.4
Gross profit	33.8	36.2	32.4	36.6
Operating expenses:				
Research and development	13.4	13.5	12.6	14.3
Sales and marketing	12.6	13.6	12.5	13.5
General and administrative	15.8	17.8	15.3	16.3
Total operating expenses	41.8	44.9	40.4	44.1
Loss from operations	(8.0)	(8.7)	(8.0)	(7.5)
Investment income	4.7	3.3	4.6	3.0
Loss before income taxes	(3.3)	(5.4)	(3.4)	(4.5)
Provision (benefit) for income taxes				
Net loss	(3.3)%	(5.4)%	(3.4)%	(4.5)%

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:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2005	2004	2005	2004
Tape Library revenues:				
TLS	43.3%	48.0%	45.9%	53.8%
RLS	12.3	16.5	12.0	12.6
	55.6	64.5	57.9	66.4
Other revenues:				
Service	13.2	9.3	13.0	10.2
Media	11.8	9.6	12.1	9.8
Power Supplies	9.9	3.4	9.3	3.4
Upgrades, Spares, Other	9.5	13.2	7.7	10.2

	100.0%	100.0%	100.0%	100.0%

Three Months Ended December 31, 2005 Compared to Three Months Ended December 31, 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 sale. Net revenues for the three months ended December 31, 2005 were $5.7 million, compared with net revenues of $6.4 million for the three months ended December 31, 2004, a decrease of $.7 million. The decrease in revenues was due primarily to an approximate $1.0 million decline in sales of tape libraries and tape drives in the current quarter compared to the second quarter of fiscal 2005. This resulted from lower sales of tape libraries and drives incorporating AIT, SAIT, and SDLT tape technology, partially offset by higher revenues from libraries incorporating LTO tape technology. The decline in sales of tape libraries was partially offset by increased revenues from service, power supplies and tape media. There were no customers providing greater than 10% of our revenues for the three months ended December 31, 2005, or December 31, 2004.

Gross Profit. Gross profit represents the difference between our net revenues and cost of goods sold. Cost of goods sold consists primarily of purchased parts, direct and indirect labor costs, rent, technical support costs, depreciation of plant and equipment, utilities, and packaging costs. Gross profit was $1.9 million, or 33.8% of net revenues, for the three months ended December 31, 2005, compared to $2.3 million, or 36.2% of net revenues, for the three months ended December 31, 2004. The decline in gross profit was primarily the result of a change in product mix, increased competitive pricing pressures, and lower overhead absorption.

Stock-Based Compensation. Stock-based compensation charges have been recognized in accordance with SFAS 123(R), adopted as of July 1, 2005. Stock-based compensation expenses for the three months ended December 31, 2005 were $37,000, allocated as follows: $3,000 to cost of goods sold; $11,000 to research and development; $5,000 to sales and marketing; and $18,000 to general and administrative.

Research and Development. Research and development expenses consist primarily of engineering salaries, benefits, outside consultant fees, and purchased parts and supplies used in development activities. Research and development expenses for the three months ended December 31, 2005 were $762,000, or 13.4% of net revenues, as compared to $865,000 or 13.5% of net revenues, for the three months ended December 31, 2004. The decrease in research and development expenses was due to lower compensation expense resulting from fewer employees, and lower prototype material costs and consulting fees.

Sales and Marketing. Sales and marketing expenses consist primarily of employee salaries and benefits, sales commissions, trade show costs, advertising, promotion and travel related expenses. Sales and marketing expenses for the three months ended December 31, 2005 were $715,000, or 12.6% of net revenues, compared to $868,000, or 13.6% of net revenues, for the three months ended December 31, 2004. The decrease in sales and marketing expenses was primarily due to lower compensation expenses resulting from fewer employees, and lower advertising and promotion expenses.

General and Administrative. General and administrative expenses consist primarily of employee salaries and benefits, provision for doubtful accounts and professional service fees. General and administrative expenses for the three months ended December 31, 2005 were $900,000, or 15.8% of net revenues, compared with $1,136,000 or 17.8% of net revenues, for the three months ended December 31, 2004. The decrease in general and administrative expenses was due primarily to lower legal and accounting expenses and reduced bad debt expenses.

Investment Income. Investment income was $266,000 in the three months ended December 31, 2005, compared to $211,000 for the three months ended December 31, 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.

Provision for Income Taxes. We did not record a provision or benefit for income taxes for either the three months ended December 31, 2005 or for the three months ended December 31, 2004. We have recorded a full valuation allowance against our net deferred tax assets due to the uncertainty surrounding the realization of these net deferred tax assets in future periods.

Six Months Ended December 31, 2005 Compared to Six Months Ended December 31, 2004.

Net Revenues. Net revenues for the six months ended December 31, 2005 were $11.8 million, compared with net revenues of $12.7 million for the six months ended December, 2004, a decrease of $.9 million. The decrease in revenues is attributed to lower revenues from tape libraries and drives, partially offset by higher revenues from power supplies, media, and service. There were no customers providing greater than 10% of our revenues for the six months ended December 31, 2005 or December 31, 2004.

Gross Profit. Gross profit was $3.8 million, or 32.4% of net revenues for the six months ended December 31, 2005, compared to $4.6 million, or 36.6% of net revenues, for the six months ended December 31, 2004. The decline in gross profit was primarily the result of a change in product mix, increased competitive pricing pressures, and lower overhead absorption.

Stock-Based Compensation. Stock-based compensation charges have been recognized in accordance with SFAS 123(R), adopted as of July 1, 2005. Stock-based compensation expenses for the six months ended December 31, 2005 were $72,000, allocated as follows: $5,000 to cost of goods sold; $18,000 to research and development; $12,000 to sales and marketing; and $37,000 to general and administrative.

Research and Development. Research and development expenses for the six months ended December 31, 2005 were $1.5 million, or 12.6% of net revenues, as compared to $1.8 million, or 14.3% of net revenues for the six months ended December 31, 2004. The decrease in research and development expenses was due to lower compensation expenses resulting from fewer employees, and lower prototype material costs and consulting fees.

Sales and Marketing. Sales and marketing expenses for the six months ended December 31, 2005 were $1.5 million, or 12.5% of net revenues, compared to $1.7 million, or 13.5% of net revenues for the six months ended December 31, 2004. The decrease in sales and marketing expenses was primarily due to decreased advertising and promotion expenses.

General and Administrative. General and administrative expenses for the six months ended December 31, 2005 were $1.8 million, or 15.3% of net revenues, compared with $2.1 million, or 16.3% of net revenues for the six months ended December 31, 2004. The decrease in general and administrative expenses was due to a decrease in compensation expenses resulting from fewer employees and lower legal expenses.

Investment Income. Investment income was $537,000 in the six months ended December 31, 2005, compared to $375,000 for the six months ended December 31, 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.

Provision for Income Taxes. We did not record a provision or benefit for income taxes for the six months ended December 31, 2005 or for the six months ended December 31, 2004. We have recorded a full valuation allowance against our net deferred tax assets due to the uncertainty surrounding the realization of these net deferred tax assets in future periods.

LIQUIDITY AND CAPITAL RESOURCES

Cash used by operating activities was $4,000 in the six months ended December 31, 2005, primarily attributed to increases in inventories, prepaids and other assets and prepaid income taxes, partially offset by a decrease in accounts receivable. Cash provided by operating activities was $135,000 in the six months ended December 31, 2004, primarily attributed to a reduction in accounts receivable.

Cash used in investing activities was $3.8 million in the six months ended December 31, 2005, primarily attributed to the purchase of marketable securities. Cash used in investing activities was $2.3 million in the six months ended December 31, 2004, primarily attributed to the purchase of marketable securities.

Cash was not used in financing activities during the six months ended December 31, 2005. Cash used in financing activities during the six months ended December 31, 2004 was $1.7 million, primarily attributed to the repurchase of 359,082 shares of our common stock.

As of December 31, 2005, we had $8.4 million in cash and cash equivalents and $25.4 million in marketable securities. We believe that our existing cash and cash equivalents plus funds available from the sale of our marketable securities will be sufficient to fund our working capital and capital expenditure needs for at least the next 12 months. We may utilize cash to invest in businesses, products or technologies that we believe are strategic. In addition, we have made and may in the future make investments in companies with whom we have identified potential synergies.

However, we have no present commitments or agreements with respect to any material acquisition of other businesses or technologies.

ITEM 3. ***Quantitative and Qualitative Disclosures About Market Risk***

We develop products in the United States and sell them worldwide. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. As all sales are currently made in U.S. dollars, a strengthening of the U.S. dollar could make our products

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less competitive in foreign markets. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We have no outstanding debt nor do we utilize derivative financial instruments. Therefore, no quantitative tabular disclosures are required.

ITEM 4. ***Controls and Procedures***

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Qualstar s disclosure controls and procedures as of December 31, 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 second quarter of fiscal 2006 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 6. ***Exhibits***

(a) *Exhibits:*

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

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SIGNATURES

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

QUALSTAR CORPORATION

By: /s/ WILLIAM J. GERVAIS
William J. Gervais
President, Chief Executive Officer

Dated: February 13, 2006

By: /s/ FREDERIC T. BOYER
Frederic T. Boyer
Principal Financial Officer

Dated: February 13, 2006

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EXHIBIT INDEX

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