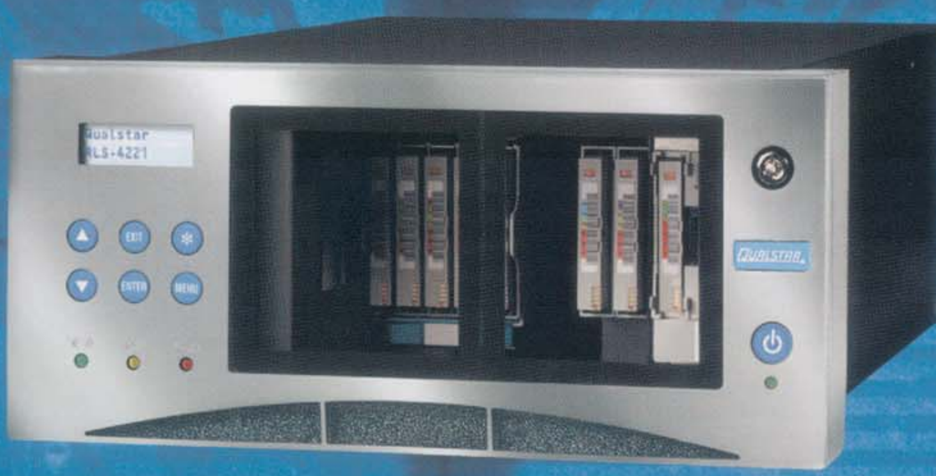
QUALSTAR®

WE HOLD THE WORLD'S RECORDS



ANNUAL REPORT 2002

November 6, 2002

Dear Shareholder:

Qualstar faced a very challenging operating environment in fiscal 2002, brought on by generally weak economic conditions which triggered a slowdown in the data storage industry. Given these challenges, I believe we produced a satisfactory year. With top-line growth compromised by the sluggish economy, we focused on achieving other goals that were just as important to the long-term health of the Company: maintaining market share; remaining profitable; maintaining balance sheet strength; and positioning Qualstar for future growth. I am pleased with the efforts we made in each of these important areas.

In our planning process, we always factor in the possibility of a downturn in the industry and the actions Qualstar must be willing to take to maintain profitable operations. While revenues for the fiscal year ended June 30, 2002 were $37.6 million, down from $51.6 million in the previous fiscal year, we remained profitable and continued to build shareholder value.

During the year, we earned $2.8 million or $0.22 per diluted share. The key to this profitability was maintaining our focus on the value-added reseller (VAR) channel, which improved our gross margin to a healthy 36.9% up from 35.6% in the prior year. Cash flow was also positive as we ended the year with $30.8 million in cash, cash equivalents and marketable securities, up from $27.1 million at the beginning of the year.

Most importantly though, we did not achieve our profitability by cutting back on critical research and development. We do not view weak economic conditions as a time to curb spending on R&D. Rather, it is an opportunity to capitalize on our positive cash flow and financial strength to continue investing in development programs in order to emerge with a stronger market position once the economy turns around.

In 2002, we significantly enhanced our R&D capabilities by establishing an Advanced Development Group in Boulder, Colorado and attracting some of the best talent in the storage industry to the Company. These steps are essential to positioning Qualstar for future growth and helping us to accomplish our goal of being a leader at producing reliable tape storage products, with a full complement of features at competitive prices.

Fiscal 2002 was a challenging year, and we demonstrated that we know how to effectively manage through tough economic cycles and continue to deliver value to you, our shareholders. We believe that the long-term opportunities in the data storage and data protection markets are exceptional, and we have a foundation in place that will enable Qualstar to build on our track record of growth and profitability.

I would like to thank all of our employees, customers, suppliers, and shareholders for their hard work and continued support during a successful 2002.

Sincerely,

William J. Gervais

William J. Gervais
President and Chief Executive Officer

On the cover: Our new RLS Series Rackmount Tape Library.

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, 2002

☐ **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

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. ☐

As of September 23, 2002, the aggregate market value of the common equity held by non-affiliates of the registrant was approximately $34,190,716.

The total shares of common stock without par value outstanding at September 23, 2002 is 12,656,101.

DOCUMENTS INCORPORATED BY REFERENCE

Items 10, 11, 12 and 13 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, 2002.

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, storage arrays of tape cartridges and robotics to move the tape cartridges from their storage locations to the tape drives under software control. Our tape libraries provide storage solutions for organizations requiring backup, recovery and archival storage of critical electronic information. Our tape libraries also can provide near-online storage as an alternative to disk drives. Our products are compatible with commonly used network operating systems, including UNIX, Windows NT, NetWare and Linux. Our tape libraries also are compatible with a wide range of storage management software packages, such as those supplied by Computer Associates, Legato, Tivioli and Veritas. We offer tape libraries for multiple tape drive technologies, including those using Advanced Intelligent Tape, DLT, and LTO tape drives and media.

We sell our tape libraries worldwide, primarily to value added resellers and original equipment manufacturers. These customers integrate our products with software from third party vendors to provide storage solutions, which they in turn resell to end users. We custom configure each of 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 the industrial distribution channels used by our competitors.

Our seven senior operations executives have worked in the computer and data storage industries for an average of approximately 26 years each. Based on this experience, we have the ability to bring new products to market in response to changing market conditions and new opportunities as they arise.

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 marketplace. 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 other tape drive technologies and tape media formats. Automated tape libraries and related products, such as tape drives and tape media, represented approximately 85.5% of revenues in fiscal 2000, approximately 89.3% of revenues for fiscal 2001, and approximately 82.9% of revenues for fiscal 2002. Sales of 9-track tape drives, services and other products accounted for the balance of our revenues.

Industry Background

Storing, managing and protecting data has become critical to the operation of many enterprises 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 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, 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 information. 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

The following factors are contributing to the 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 and archival storage of data. We believe that the need to utilize databases 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.* The growth in data is being fueled not only by the increase in information but also in the types of stored data. For example, storage of 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.
- *Growth in 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.
- *Growth in network server computing applications and data.* The use of server-based computer networks has shifted critical information and applications to network servers in order 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, e-mail and voicemail, all of which generate progressively more data. Organizations increasingly are 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. Decreases in costs not only encourage the storage of more data, but also make it more cost effective to add storage capacity rather than to remove old data, contributing to greater storage demand for data which in the past may have been purged periodically.

Advances in Storage Management Technologies

The growth in data and need for storage is contributing to an evolution in traditional storage solutions. New open standard technologies are designed to provide high-speed connectivity for data-intensive applications across multiple operating systems, including UNIX, Windows NT, NetWare 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 currently exists with traditional technologies. Additionally, SANs are able to provide these benefits across multiple operating systems.
- *Advanced storage management software*. The development of advanced storage management software has led to the use of tape as a lower-cost alternative to disk drives for on-line storage. 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 and put it back on the disk file for user access. This sometimes is referred to as near-online storage. This process reduces the overall storage cost by using the least expensive storage medium to save data that is not expected to be needed on a frequent basis. Advances in storage management software have increased the ability of businesses to store, manage and retrieve important 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 library directly into a network without increasing demands on the file server or 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 three technologies: magnetic disk, optical disk and magnetic tape. Each of these solutions represents 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 natural disasters. Magnetic and optical disks provide quicker access to stored data and generally are used when speed is important. Less frequently used data often is migrated from magnetic or optical disks to tape storage. Tape libraries provide a near-online solution, where less frequently used data files are stored on tapes instead of on disks.

Tape Libraries and Applications

Automated tape libraries speed 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 also are capable of being operated from a remote location or during off-hours when no attendant is on duty. Automated tape libraries are a key component of a network administrator's overall storage solution.

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 recovery in the event the original data 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 physical or natural disaster at the primary site.

- *Archiving*. Archiving is the storage of data for historical purposes. When important information is stored on tape, automated tape libraries, in conjunction with storage management software, 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 for other purposes. Tape libraries also are used for archiving because of the benefits offered by the tape medium, such as long-term data integrity, resistance to environmental contamination, ease of relocation, and low cost. Additionally, the availability of "write once read many" or worm tapes and tape drives is expected to be used in archiving processes where data once written cannot be modified.

- *Digital video*. Digital recording of camera images for surveillance and security purposes is beginning to replace traditional analog VHS recording in mid-size to large installations such as airports, retail stores, government facilities and gaming operations. This is a growing and increasingly important market opportunity because tape libraries eliminate the need for operators to load, unload, store and retrieve the vast number of tapes created in these facilities. Library based systems index, store and play back the video images on demand, thereby reducing the recall time and cost of operation significantly when compared to VHS recording and playback devices. Digital recording technology provides enhanced resolution and accommodates the recording of transactional data such as cash register transaction data and credit card data alongside the video image, which is not possible with 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. Tape library storage of a digitized image costs considerably less than storing a film copy, and can be recalled years later with considerably less effort. Additionally, there is a trend to require that these records be kept available for longer periods of time.

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 original equipment manufacturers. Many organizations, however, do not have sufficient in-house resources but often 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 storage management 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 storage management software, and marketing and technical support. We expect the market segment served by value added resellers to increase as the cost of tape library storage continues to decline and as more organizations choose to outsource their information technology functions.

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 reseller distribution 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 Solution

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 product 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 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, assembly and testing of our products which reduces the potential for product failures and results in products that require little maintenance.

The technology utilized within 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 in order to prevent our product lines from becoming obsolete. To give a few examples, this year we completed development of our Q-Link™ remote library management tool, our 2 Gigabit per second Fibre Channel interface option, and our exclusive Variable I/O Port feature. The Q-Link™ remote library management tool enables administrators to manage multiple Qualstar tape libraries from one centralized location using a standard web browser. Our 2 Gigabit per second Fibre Channel option essentially doubled the performance of our existing Fibre Channel solution. The Variable I/O Port was introduced to allow IT administrators the ability to select the number of cartridge slots which can be dedicated to bulk import or export of media to or from the library.

Our tape libraries are compatible with over forty third-party storage management software packages, such as those supplied by Computer Associates, Legato, Tivoli and Veritas. 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 the lack of compatibility is a significant barrier to entry for new tape library competitors. To ensure compatibility, our engineers work closely with the application software vendors during product development cycles. We do not have contracts with any application software vendors, nor do we need access to their software code to design our products. We maintain relationships with them by supplying evaluation 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 as to current and contemplated changes to our products and by referring business to them when value added resellers or end users inquire about software sources.

We have focused our business primarily on supporting value added resellers and original equipment manufacturers as the most effective and profitable distribution channels for our tape libraries. Our solution is to offer our resellers reliable tape libraries, multiple tape format choices, and more attractive profit opportunities than do other tape library manufacturers. We custom configure each of our libraries based on the resellers' requirements, with a normal delivery time of one to three working days. Our solution for original equipment manufacturers is to offer them control over product design changes, qualification testing, custom colors and private labeling. We believe these factors enhance the resellers' and original equipment manufacturers' ability to sell our products and encourage them to remain loyal to Qualstar.

Strategy

Our goals are to enhance our position as a supplier of automated tape libraries and to 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 Advanced Intelligent Tape, Digital Linear Tape (DLT), and Linear Tape Open, or LTO Ultrium tape media formats. 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 their end-user customers.

- *Focus distribution 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 increase the likelihood of closing a sale and to increase the reseller's profit margins. We intend to maintain our marketing presence in support of this distribution channel. We conduct business with our value added resellers on an individual purchase order basis and no long-term commitments are involved. Additionally, there are no exclusive territories assigned to our value added resellers.

- *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 will continue to pursue and develop opportunities with original equipment manufacturers. We conduct business with our original equipment manufacturer customers on an individual purchase order basis and no long-term commitments are used.

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

- *Increase our rate of innovation.* We plan to increase research and development resources in order 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 manufacturing 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 produce all of our products at a single facility and 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, and maintain our profitability.

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	Models in Product Family	Tape Drive Technology	Range of Tape Cartridges	Maximum Capacity in Terabytes (1)
TLS-4000	12	Sony AIT2, AIT3	12 to 600	60.0
TLS-6000	7	Quantum DLT—8000	10 to 240	9.6
		Quantum SDLT220,320	10 to 240	38.4
TLS-8000	7	LTO	11 to 264	26.4
CLS-4000	1	Sony AIT2, AIT3	16	1.6
RLS-4000	1	Sony AIT2, AIT3	22	2.2

(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%.

Some of our tape library product 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 seven to thousands of tapes. We concentrate our product offerings in the middle segment 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. Within the library, tape cartridges sometimes are stored in removable magazines, allowing for bulk removal of the tapes. Most of our libraries also offer key features such as barcode readers to scan cartridge labels, and an input/output port for importing and exporting individual tapes under system control. Many of our library models are expandable after installation 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 offer automated tape libraries with different data storage capacities and data transfer rates. 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 develop enhancements and improvements for our existing products in order to maintain our competitive position in the marketplace.

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 1 or 2 Gigabit per second Fibre Channel option on most of our models to meet the needs of 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 robotic motion that is smooth, repeatable and highly reliable.
- *Brushless motors.* We use only brushless electric motors in our tape libraries. Motors are a key component in any robotic system. 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 I/O Port.* Our new VIOP feature allows IT administrators the ability to select the number of cartridge slots which can 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 must be administered from a single location. With our new Q-Link™ tool, our customers have the ability to put our products 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 table top, without the need for a special equipment rack. If requested, we provide our customers with an adapter kit for mounting in a rack. Other manufacturers design libraries primarily for rack-mounting, and supply an adapter for table-top use. We have chosen our approach to distinguish ourselves from many of our competitors. We believe that this approach provides the most convenient and lowest cost solution for the largest segment of our customer base.

Recently we commenced shipments of the first model in our planned RLS Series of tape libraries. These products are designed to fit conveniently 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, the RLS was designed to allow for dual-redundant power supplies as well as hot-swappable tape drives. We believe these features will give the RLS Series of tape libraries a competitive advantage over other compact rack-mount tape libraries that do not offer as robust a combination of features. We believe this product will provide a convenient solution for a large portion of our customer base.

Other Products

We have manufactured 9-track auto-loading reel-to-reel tape drives since 1990. Demand for 9-track tape drives has been declining for many years, and we expect overall demand for 9-track tape drives to continue to decline in the future. Therefore, this year we announced the end of the life for 9-track tape drives. In addition to our tape libraries and 9-track tape drives, we sell ancillary products such as tape media, tape magazines, cables, bar code labels and adapters for rack mounting our products.

In July of 2002, we purchased the assets and intellectual property of N2Power, Inc., a privately held company located in Newbury Park, California. N2Power designs the smallest and most efficient open-frame switching power supplies available today based upon its patented technology. Since the purchase, N2Power has been relocated to our facility in Simi Valley, California. N2Power products are utilized within our tape libraries as well as sold on the open market primarily to OEM customers.

Sales and Marketing

Sales

We sell our tape library products primarily through value added resellers. Our direct sales force usually will initiate contact with value added resellers who might be likely 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 force resellers to purchase through distributors and who sometimes sell directly to end users, thereby competing with their own resellers. Some of the advantages of our strategy include the following:

- *Higher profit margins*. By avoiding the extra distribution markup, higher profit margins are available to be shared by both us and the reseller.
- *Custom configurations*. By circumventing the distribution step, we are able to offer custom configurations of our products, such as special paint, private branding and non-standard interface options, on very short notice.
- *Channel conflicts avoided*. We refer all end-user inquiries to our reseller partners. Because they know that we will not sell directly to the end user, there is an attitude of cooperation between the reseller and us. Frequently, our sales representatives make end-user visits with the reseller to answer questions or help close the sale.
- *Credit*. We typically extend credit to resellers if they meet our credit requirements.
- *Rapid delivery*. We generally ship a product to the reseller within one to three working days of confirming an order, rivaling the delivery time of many distributors.

We have relationships with over 130 value added resellers, and approximately forty independent storage management software vendors. Our sales are made on an individual purchase order basis.

Although we sell our tape libraries primarily to value added resellers, we believe that original equipment manufacturers are an important element of our business. We strive to work with original equipment manufacturers early in the product development cycle so that we can obtain valuable product development feedback. The sales cycle for original equipment manufacturers generally encompasses six months to one year and involves extensive product and system qualification testing, evaluation, integration and verification. Most of our sales of automated tape libraries to original equipment manufacturers are in the video surveillance and medical imaging segments. Original equipment manufacturers typically assume responsibility for product sales, service and support.

Our sales are spread across a broad customer base, with our largest original equipment manufacturer, Loronix Information Systems, a division of Verint Systems, accounting for 21.7% of revenues in fiscal 2000, 15.4% of revenues in fiscal 2001, and 8.2% of revenues in fiscal 2002. Stornet, Inc., historically our largest value added reseller accounted for 11.5% of our revenues in fiscal 2000, 13.8% of revenues in fiscal 2001, and 9.4% of revenues for the fiscal year ended June 30, 2002.

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 Frankfurt, Germany. We intend to continue to develop our international markets and create additional outlets for our products. All of our international sales are denominated in U.S. dollars. Revenues from sales to customers located outside the United States were $12.6 million, or 25.8% of revenues in fiscal 2000, $14.5 million, or 28.2% of revenues in fiscal 2001, and $12.1 million or 32.2% of revenues in fiscal 2002.

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 network systems publications such as SYS Admin, Infostor, LANline, Integrated Solutions and others, and participate in trade shows. We display our products under the Qualstar brand name at various trade shows including The COMDEX Fall trade show, and participate in other trade shows in partnership with our principal suppliers and resellers. We support our marketing and customer service with a website that features comprehensive marketing and product information.

Another element of our marketing plan is our lead registration program. This program awards value added resellers that uncover sales opportunities and promote our products to the end user. In exchange for this effort, the reseller is rewarded with a higher profit margin on that particular sale. The lead registration program gives our reseller partners an advantage over their competitors who purchase from distribution channels.

Our direct sales force conducts seminars targeting end users, often with a sales representative from one of the storage management software vendors. In addition, 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.

Customer Service and Support

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

- *Technical support*. Our technical support personnel are available Monday through Friday during normal business hours. 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, which are fulfilled by IBM and Anacomp.
- *Sales engineering*. Our engineers provide both pre-and post-sales support to our resellers. Systems 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. Systems engineers work with resellers and end users over the telephone and, in certain situations, visit the customer's site.
- *Training*. We offer a product maintenance training program for end users, value added reseller and original equipment manufacturer maintenance personnel. We conduct our training classes at our headquarters, as well as on-site at the locations of our value added resellers or original equipment manufacturers.
- *Warranty*. The standard warranty period on our tape libraries is three years. During the first year we offer immediate replacement of defective products at no charge, subject to availability and credit approval of the purchaser. The purchaser is responsible for returning the defective product to us in a timely manner without damage. After the first year, the customer must first ship the tape library to our factory, where we will service the product during the warranty period at no charge. We offer out-of-warranty factory service at a flat fee plus applicable taxes, duties and transportation costs. For library tape drives, we pass the drive manufacturer-provided warranty on to our reseller. On-site service for library products is available within the United States and some foreign countries for an extra charge. We contract with outside service providers to supply on-site service.

Revenues from the sale of on-site service contracts and out-of-warranty repair have not been significant.

Manufacturing and Suppliers

We manufacture our products at our facility in Simi Valley, California. The CLS-4000 is purchased from an outside supplier. We currently operate three 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.

In order to respond rapidly to sales orders, we build our tape libraries to a semi-finished state in advance of receipt of an order, 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 tape libraries to a semi-finished state is approximately five working days. We believe that this capability represents an effective way to control our inventory levels while maintaining the ability to fill specific customer 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 a product order, we generally ship the product to the customer 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 sales.

We select our suppliers carefully 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 standard 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 recording 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. We have experienced only one situation involving a limited supply of components. Between January 1999 and January 2000, Sony Electronics, Inc., our sole-source supplier of Advanced Intelligent Tape drives and tape media, was unable to provide us with sufficient quantities of 50 gigabyte tape media to meet our order volume. During this period, our customers generally did not delay purchases of Advanced Intelligent Tape libraries from us because of this shortage, but accepted delivery of tape libraries with a partial shipment of 50 gigabyte tape media or accepted 36 gigabyte tape media, which was available.

Competition

The market for automated tape libraries is intensely competitive, highly fragmented 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 StorageTek, Quantum/ATL Products, Advanced Digital Information Corporation, Exabyte, Overland Data, and Spectra Logic.

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. However, we do not believe that our current determination not to seek ISO-9000 certification has affected our sales to date.

As a greater number of competitors introduce products in a particular tape drive technology, the increased competition normally results in price erosion, a reduction in gross margins and a loss of market share 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 sales 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, 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 network operating systems and storage management software;
- after-sale expandability of a tape library to meet increasing storage requirements;
- expected product life and cost of maintenance; and
- physical configuration and power requirements of the library.

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

Research and Development

Our research and development group of 27 people consists of two engineering teams who have data storage and related industry experience. Our original team located in Simi Valley, California, has developed over 30 separate tape library models for ten different tape formats over the last six years. This year we began our Advanced Development Group in Boulder, Colorado. They are responsible for the design and development of our next generation of tape libraries. Our engineers are a diverse and robust group that have the capability to meet the needs of a complex and demanding data storage market.

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, 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, as well as SCSI and Fibre Channel interface technologies.

We frequently develop new products in response to the availability of 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 various 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 giving us the ability 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 and 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 $1.0 million in fiscal 2000, $1.3 million in fiscal 2001, and $2.1 million for the year ended June 30, 2002. We anticipate increasing our spending on research and development in the future, to increase the flow of new products to market.

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 nondisclosure agreements with our development engineers 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 12, 2002, we had 115 full-time employees, including 44 in manufacturing, 27 in research and development, 6 in customer service, 19 in sales and marketing, and 19 in finance and administration. 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 and marketing resources to developing 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 recent years several of our competitors have:

- acquired other tape library companies;
- increased the geographic scope of their market;
- offered a wider range of tape library products; and
- acquired proprietary software 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. However, our current dependence on a limited number of executives, 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 85.5% of our revenues in fiscal 2000, approximately 89.3% of our revenues for fiscal year 2001, and approximately 82.9% of our revenues for the year ended June 30, 2002. 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. Several tape drive manufacturers, including Sony Corporation, Quantum Corporation, and Hewlett Packard, 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 8 millimeter Advanced Intelligent Tape tape drives and media. Sony has allocated some of their products and may allocate them again in the future. In the fiscal year 2000 we derived $40.0 million, or 81.0%, of our revenues, in fiscal 2001 we derived $39.8 million, or 77.1%, of our revenues, and in fiscal 2002 we derived $20.7 million, or 55.1% of revenues from the sale of libraries, tape drives and tape media based on Sony Advanced Intelligent Tape technology. 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 DLT and SDLT 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 DLT and SDLT tape drive requirements.

- The Linear Tape Open standard was developed by an industry consortium consisting of IBM, Hewlett Packard and Seagate. LTO is intended to compete with 8mm and other half-inch tape drives and media. IBM and Hewlett Packard both manufacture and 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 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; and

- our costs may increase as value added resellers generally require a higher level of customer support than do original equipment manufacturers.

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 or that it refrain from purchasing competing products.

We do not have any exclusive or long-term 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 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 storage products incorporating technologies other than tape gain comparable or superior market acceptance, our business could be harmed.

Two customers account for a significant portion of our sales and they have no minimum or long-term purchase commitments. Our revenues and earnings may decrease if we lose business from these customers.

Loronix Information Systems, a division of Verint Systems Inc., accounted for 21.7% of our revenues during fiscal 2000, 15.4% of revenues during fiscal 2001, and 8.2% of our revenues during fiscal 2002. StorNet, Inc., our largest value added reseller, accounted for 11.5% of our revenues during fiscal 2000, 13.8% during fiscal 2001, and 9.4% of our revenues during fiscal 2002. We cannot assure you that these customers will continue to purchase our products in the quantities they have purchased in the past, or at all. Our revenues and earnings may decrease if any of the following factors were to occur relating to either of these customers:

- any financial difficulties of the customer that results in its inability to pay amounts owed to us. StorNet, our largest VAR, has had financial difficulties and as a result, we believe that it is unlikely they will continue as a re-seller of our products. Due to their difficulties, we increased our allowance for doubtful accounts by $1.5 million during the fourth quarter of fiscal 2002.
- the loss of the customer due to competition from other vendors or consolidation; or
- substantial cancellations of orders by the customer, or the receipt of orders significantly below historical or anticipated levels.

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 may fluctuate in the future due to several factors, including:

- reductions in the size, delays in the timing, or cancellation of significant customer orders;
- fluctuations in product 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;
- 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.

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 sales, 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 tape libraries 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 recently introduced RLS family of automated tape libraries. The RLS is our "next generation of automated tape libraries" designed for the rackmount automated tape library marketplace. The RLS and the TLS families of tape libraries are facing increasing competition from automated tape library products and likely will 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.

We depend upon independent software developers to provide software that integrates our libraries with computer operating systems.

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 independent third party software developers 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 developers 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 independent software developers, we maintain relationships with them by:

- supplying evaluation 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 our products to us for any reason. 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 harmed for the periods during which returns are made.

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

Many of our 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 efforts 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.

Sales to customers located outside the United States accounted for approximately 25.8% of our revenues in fiscal 2000, 28.2% in fiscal 2001, and 32.2% in fiscal 2002. We believe that international sales will continue to represent a significant portion of our revenues. Our foreign 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;
- 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 products, may reduce sales.

These risks may increase our costs of doing business internationally and reduce our sales 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 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. While we currently are not engaged in any intellectual property litigation or proceedings, we may become involved in these proceedings in the future. We have from time to time and in the future may be subject to 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 our 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 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 44.5% of our outstanding common stock. 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 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 intend to continue this policy for the foreseeable future to strengthen our financial and competitive position in the tape library market.

Item 2. Properties

Qualstar leases all of the facilities used in our business. Our headquarters, manufacturing, TLS and RLS engineering, and N2 Power are located in a single building containing approximately 57,000 square feet located in Simi Valley, California. 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.

Qualstar also leases 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, Qualstar maintains small offices in Rhode Island, San Diego, CA and Frankfurt, Germany.

Item 3. Legal Proceedings

We may be involved in legal proceedings from time to time in the ordinary course of business. However, there are currently no material legal proceedings pending or, to our knowledge, threatened against us.

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, 2002.

MANAGEMENT

Executive Officers

Officers are elected by and serve at the discretion of the board of directors. The executive officers of Qualstar as of September 27, 2002 are:

Name	Age	Position
William J. Gervais	59	Chief Executive Officer, President and Director
Richard A. Nelson	59	Vice President of Engineering, Secretary and Director
Thomas J. Studebaker	60	Vice President of Advanced Development
Matthew Natalizio	47	Vice President and Chief Financial Officer
David L. Griffith	46	Vice President of Operations
Mark R. Gilmore	52	Vice President of Sales
Robert K. Covey	54	Vice President of Marketing

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 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 in 1966.

Tim Studebaker has been our Vice President of Advanced Development since April of 2002. From 1997 to 2002, Mr. Studebaker was Vice President of Engineering, Storage Automation & Solutions Division of Exabyte Corporation. From 1991 to 1997, Mr. Studebaker was Director of New Product Development for Exabyte Corporation. Mr. Studebaker acted as Packaging and Robotic Development Manager of Storage Technology Corporation from 1977 to 1991. In 1966, Mr. Studebaker received a B.S. in Mechanical Engineering from the University of Colorado. Mr. Studebaker received his Post Graduate Certificate from the U.S. Army Management Engineering Training Agency in 1996.

Matthew Natalizio has been our Vice President and Chief Financial Officer since 2000. Prior to joining Qualstar, Mr. Natalizio served as Vice President of Finance and Treasurer from 1994 until 1998, and as Vice President, Operations Support from 1998 through 1999, of Superior National Insurance Group, Inc. From 1988 until 1994, Mr. Natalizio was a Senior Audit Manager for KPMG Peat Marwick LLP. From 1983 through 1988, Mr. Natalizio was an Audit Manager for Ernst & Whinney. Mr. Natalizio received a B.A. degree in Economics from the University of California, Los Angeles in 1977 and became a C.P.A. in 1985.

Dave 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. From 1985 to 1987, Mr. Griffith was Director of Disk Operations for Ibis Systems Inc. From 1982 to 1985, Mr. Griffith acted as a Principle Engineer for Micropolis Corporation. Mr. Griffith received a degree in Mechanical Engineering from California State Polytechnic University in 1980.

Mark R. Gilmore has been our Vice President of Sales since January of 2002. From 1976 to January of 2002, Mark was the General Manager of OEM Products and National Sales Manager at Kodak Corporation. In 1985, Mark obtained an M.B.A. from Marquette University. In 1972, Mark graduated from Grove City College where he received a B.A. degree in Accounting.

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 from 1965 to 1968.

PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

Qualstar commenced its initial public offering of common stock on June 23, 2000. 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 2000:			
Fourth Quarter	June 23—June 30, 2000	$ 7.72	$7.00
Fiscal 2001:			
First Quarter	July 1—September, 30, 2000	$13.50	$7.00
Second Quarter	October 1—December 31, 2000	$14.75	$6.00
Third Quarter	January 1—March 31, 2001	$ 9.13	$5.31
Fourth Quarter	April 1—June 30, 2001	$ 8.00	$5.94
Fiscal 2002:			
First Quarter	July 1—September, 30, 2001	$ 6.92	$4.45
Second Quarter	October 1—December 31, 2001	$ 6.05	$4.37
Third Quarter	January 1—March 31, 2002	$ 7.61	$5.94
Fourth Quarter	April 1—June 30, 2002	$ 7.40	$5.58

There were approximately 1,916 beneficial owners of Qualstar's common stock as of September 23,2002.

Qualstar has declared no cash dividends during the periods reported. Qualstar does not 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 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,				
	1998	1999	2000	2001	2002
	(in thousands, expect per share amounts)				
Statements of Income Data:					
Net revenues	$19,155	$29,698	$49,352	$51,572	$37,631
Cost of goods sold	12,892	19,058	30,915	33,216	23,753
Gross profit	6,263	10,640	18,437	18,356	13,878
Operating expenses:					
Research and development	894	925	1,027	1,279	2,136
Sales and marketing	1,277	1,941	2,643	3,399	3,048
General and administrative	1,062	1,267	2,057	3,301	5,222
Total operating expenses	3,233	4,133	5,727	7,979	10,406
Income from operations	3,030	6,507	12,710	10,377	3,472
Interest income	35	41	54	1,225	1,133
Impairment of investment	—	—	—	(1,050)	—
Income before income taxes	3,065	6,548	12,764	10,552	4,605
Provision for income taxes	1,132	2,562	4,968	3,824	1,845
Net income	1,933	3,986	7,796	6,728	2,760
Premium paid on redemption of preferred stock	(147)	—	—	—	—
Net income applicable to common shareholders	$ 1,786	$ 3,986	$ 7,796	$ 6,728	$ 2,760
Earnings per share:					
Basic	$ 0.28	$ 0.60	$ 1.10	$ 0.54	$ 0.22
Diluted	$ 0.19	$ 0.42	$ 0.80	$ 0.53	$ 0.22
Shares used to compute earnings per share:					
Basic	6,404	6,629	7,119	12,372	12,475
Diluted	9,290	9,467	9,742	12,668	12,664

	June 30,				
	1998	1999	2000	2001	2002
	(in thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$ 798	$ 2,134	$18,976	$20,809	$16,363
Working capital	7,213	11,205	33,620	43,382	46,507
Total assets	8,461	12,950	37,984	47,878	50,758
Total debt	—	—	—	—	—
Shareholders' equity	7,614	11,640	35,032	44,689	47,973

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 those using Advanced Intelligent Tape, DLT, SDLT, and Linear Tape Open, or LTO, 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 large libraries, we developed a family of tape libraries over the last seven years spanning a broad range of tape formats, prices, capacity and performance. Our product mix has changed over the last five fiscal years as we introduced new products to address additional tape formats and changing customer preferences. For example, during fiscal year 2002, we introduced a new rack-mount library compatible with AIT technology. We expect our product mix 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 storage solutions to end users that are installed complete and ready to operate. 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. We assist our customers with marketing 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 Frankfurt, Germany. We intend to continue to develop our international markets and create additional outlets for our products. All of our international sales are denominated in U.S. dollars. Revenues from sales to customers located outside the United States were $12.6 million, or 25.8% of revenues in fiscal 2000, $14.5 million, or 28.2% of revenues in fiscal 2001, and $12.1 million, or 32.2% of revenues in fiscal 2002.

Net revenues include revenues from the sale of tape libraries, library tape drives, storage media, and ancillary products. Ancillary revenues include service and repair, net of the cost of any third party service contracts, extended warranty revenues, and 9-track tape drives, which we announced end-of-life in fiscal year 2002. Automated tape libraries and related products, such as tape drives and tape media, represented approximately 85.5% of revenues in fiscal 2000, and 89.3% of revenues in fiscal 2001, and 82.9% of revenues in fiscal 2002. Sales of services and other products 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 of strong customer demand and less competition. Our gross margins have benefited from a shift in demand towards our larger tape libraries. However, some customers of larger tape libraries desire significant quantities of tape media. Sales of large quantities of tape media partially offset the higher gross margins associated with sales of larger tape libraries because tape media provide significantly lower gross margins than tape libraries. From time to time, we have been unable to meet demand for tape media because of supply constraints. We may experience higher gross margins in quarters when sales of tape media decrease due to supply constraints and lower gross margins in quarters when sales of tape media increase due to greater availability. We expect that our growth in revenues and attractive gross margins will encourage new competitors to enter our marketplace, which may affect our gross margins.

Research and development activities include the design and development of new products, as well as enhancements to existing products. In an effort to increase the flow of new products to market, we will continue to increase our spending on research and development activities. To this end, we recently established the Advanced Development Group in Boulder, Colorado. This group is focusing on the development of our next generation family of automated tape libraries.

We expect selling, general and administrative expenses will increase in fiscal 2003, exclusive of bad debt expenses, due to the increasing cost of employee benefits and the higher cost of being a public company, such as increased premiums for directors and officers liability insurance, and legal and accounting fees and expenses.

We recorded deferred compensation of approximately $1.7 million in the third quarter of fiscal 2000, representing the difference between the exercise prices of the options and restricted stock awards 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 the deferred compensation was approximately $227,000 during fiscal 2000, $437,000 during fiscal 2001, and $430,000 during fiscal 2002, which was recorded as general and administrative expenses in the statements of income. Total deferred compensation amortization will approximate $430,000 in fiscal 2003, and $201,000 in fiscal 2004. These approximations may vary if individuals to whom the deferred compensation amounts relate leave prior to fiscal 2004.

Results of Operations

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

	Years Ended June 30,		
	2000	**2001**	**2002**
Net revenues	100.0%	100.0%	100.0%
Cost of goods sold	62.6	64.4	63.1
Gross margin	37.4	35.6	36.9
Operating expenses:			
Research and development	2.0	2.5	5.7
Sales and marketing.	5.4	6.6	8.1
General and administrative	4.2	6.4	13.9
Income from operations	25.8	20.1	9.2
Interest income.	0.1	2.4	3.0
Impairment of investment	—	(2.0)	—
Income before income taxes	25.9	20.5	12.2
Provision for income taxes	10.1	7.4	4.9
Net income	15.8%	13.1%	7.3%

Fiscal 2002 Compared to Fiscal 2001

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, 2002 were $37.6 million, a decrease of 27.0% compared to net revenues of $51.6 million for the year ended June 30, 2001. The decrease in revenues was due primarily due to an overall decline in the data storage market, which reflects the softness seen in the global economy. Revenues from tape libraries and related media decreased to $31.2 million, or 82.9% of revenues, in the year ended June 30, 2002 from $46.0 million, or 89.3% of revenues, in the year ended June 30, 2001. Selling prices of our libraries remained relatively stable during fiscal 2002. However, selling prices of 8mm library tape drives declined during fiscal 2002, whereas half-inch library tape drives increased in overall selling price. The decline in selling prices of 8mm tape drives was attributable to reduced costs for these drives from our supplier, which were passed through to our customers in the form of lower selling prices. Half-inch library tape drives increased in selling price due to the introduction of new, more expensive LTO and DLT tape drives.

Gross Profit. Gross profit was $13.9 million, or 36.9% of revenues, for the year ended June 30, 2002, compared to $18.4 million, or 35.6% of revenues, for fiscal 2001. Cost of goods sold consists primarily of direct labor, purchased parts, depreciation of plant and equipment, rent, utilities, and packaging costs. The increase in gross margin as a percentage of revenues was primarily caused by product mix.

Research and Development. Research and development expenses consist of engineering salaries, benefits, purchased parts and supplies used in development activities. Research and development expenses for the year ended June 30, 2002 increased 67.0% to $2.1 million as compared to $1.3 million for the year ended June 30, 2001. This increase was due primarily to costs associated in bringing our new rack-mount library to market. In addition, we opened an Advanced Development office in Boulder, Colorado. Although not fully operational at June 30, 2002, there were nominal costs incurred in establishing this research and development facility during fiscal 2002. We anticipate that research and development expenses will significantly increase in fiscal 2003.

Sales and Marketing. Sales and marketing expenses consist primarily of employee salaries, benefits, sales commissions, trade show costs, advertising, technical support and travel related expenses. Sales and marketing expenses decreased 10.3% to $3.0 million, or 8.1% of revenues for the year ended June 30, 2002, as compared to $3.4 million, or 6.6% of revenues, for the year ended June 30, 2001. This decrease was due primarily to the decrease of commissions paid to our sales force as a result of lower sales.

General and Administrative. General and administrative expenses include employee salaries and benefits, deferred compensation related to equity incentives, provisions for doubtful accounts and returns, and professional service fees. General and administrative expenses increased to $5.2 million for fiscal 2002 as compared to $3.3 million for fiscal 2001. As a percentage of revenue, general and administrative expenses increased to 13.9% for the year ended June 30, 2002 as compared to 6.4% for the year ended June 30, 2001. The increase in general and administrative expenses was caused primarily by an increase in our allowance for doubtful accounts of approximately $1.6 million primarily due to the potential insolvency of a large customer.

Investment income. Investment income decreased to $1.1 million in the year ended June 30, 2002 as compared to $1.2 in the year ended June 30, 2001. This decrease was due to primarily to a poor performing economy in which overall interest rates have been low partially offset by an increase in funds available for investment.

Provision for Income Taxes. The provision for income taxes was $1.8 million, or 40.1% of pre-tax income, for fiscal 2002 compared to $3.8 million, or 36.2% of pre-tax income, for fiscal 2001. The increase in the percentage of the provision for income taxes to pre-tax income was primarily due to a higher than anticipated state apportionment factor for California income taxes.

Fiscal 2001 Compared to Fiscal 2000

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, 2001 were $51.6 million, an increase of 4.5% compared to net revenues of $49.4 million for the year ended June 30, 2000. This increase in revenues was due primarily to increasing demand for our existing tape library models. Revenues from tape libraries and related media increased to $46.1 million, or 89.3% of revenues, in the year ended June 30, 2001 from $42.3 million, or 85.5% of revenues, in the year ended June 30, 2000. Partially offsetting the increase in revenues from our tape libraries was a decrease of $2.7 million in revenues from our 9-track tape drives to $1.1 million for the year ended June 30, 2001 from $3.8 million in the year ended June 30, 2000. We expect sales of 9-track tape drives to continue to decline, as this product line is near its end of life. Selling prices of our libraries remained relatively stable during fiscal 2001. However, selling prices of tape media and library tape drives declined during the third and fourth quarter of fiscal 2001. The decline in selling prices of tape media and drives was the result of AIT tape drives and media being placed in general distribution by the manufacturer.

Gross Profit. Gross profit was $18.4 million, or 35.6% of revenues, for the year ended June 30, 2001, compared to $18.4 million, or 37.4% of revenues, for fiscal 2000. 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 primarily caused by declines in selling prices of tape media and library tape drives coupled with an increase in sales of those products.

Research and Development. Research and development expenses consist of engineering salaries, benefits, purchased parts and supplies used in development activities. Research and development expenses for the year ended June 30, 2001 increased 24.5% to $1.3 million as compared to $1.0 million for the year ended June 30, 2000. This increase was due primarily to an increase in salaries resulting from an increase in departmental headcount and for research and development of new products and new features of our existing products.

Sales and Marketing. Sales and marketing expenses consist primarily of employee salaries, benefits, sales commissions, trade show costs, advertising, technical support and travel related expenses. Sales and marketing expenses increased 28.6% to $3.4 million, or 6.6% of revenues for the year ended June 30, 2001, as compared to $2.6 million, or 5.4% of revenues, for the year ended June 30, 2000. This increase was due primarily to the growth in our sales force and associated increases in salaries and benefits of $486,000, and an increase in sales commissions of $134,000.

General and Administrative. General and administrative expenses include employee salaries and benefits, deferred compensation related to equity incentives, provisions for doubtful accounts and returns, and professional service fees. General and administrative expenses increased to $3.3 million for fiscal 2001 as compared to $2.1 million for fiscal 2000. As a percentage of revenue, general and administrative expenses increased to 6.4% for the year ended June 30, 2001 as compared to 4.2% for the year ended June 30, 2000. The increase in general and administrative expenses were caused by one time expenses of $230,000 associated with the move to our new facility, increased costs of being a publicly traded company such as directors and officers insurance and investor relations expenses, higher rent as the result of our move to a new facility, and higher salaries and benefits for administrative staff. The year ended June 30, 2001 also includes deferred compensation amortization expense of $437,000 related to equity incentives, as compared to only $227,000 of deferred compensation amortization expense in the year ended June 30, 2000.

Impairment of investment. During the fourth quarter of fiscal 2001, we determined that the carrying value of our investment in Chaparral Network Storage, Inc. exceeded its net realizable value as a result of rapid changes in technology and the availability of capital for further development of its family of products. Accordingly, we recognized an allowance in the amount of $1,050,000 to reduce the carrying value of the investment in Chaparral to zero.

Investment income. Investment income increased to $1.2 million in the year ended June 30, 2001 as compared to $54,000 in the year ended June 30, 2000. This increase was due to a full year of investment of the initial public offering proceeds. In addition, net cash generated by our operations in fiscal 2001 was invested in interest bearing securities.

Provision for Income Taxes. The provision for income taxes was $3.8 million, or 36.2% of pre-tax income, for fiscal 2001 compared to $5.0 million, or 38.9% of pre-tax income, for fiscal 2000.

Liquidity and Capital Resources

Historically, we have funded our capital requirements with cash provided by operations. Cash provided by operating activities were $2.6 million in fiscal 2000, $6.6 million in fiscal 2001, and $4.1 million in fiscal 2002.

In each of these periods, operating cash was provided primarily by net income. During fiscal 2000, cash flow from operating activities was primarily used to fund increases in receivables and inventory. In fiscal 2001, cash flow from operating activities was primarily used to fund increases in inventories and the purchase of marketable securities. In fiscal 2002, cash flow from operating activities was primarily used to purchase marketable securities.

Cash used in investing activities was $1.1 million in fiscal 2000, $7.2 million in fiscal 2001, and $8.8 million in fiscal 2002. Cash used in investing activities in fiscal 2000 related primarily to our investment of $1.1 million for an approximately 1% interest in Chaparral Network Storage, Inc., a provider of Fibre Channel interfaces. Cash used in investing activities for fiscal 2001 and 2002 related primarily to purchases of marketable securities as well as equipment and leasehold improvements.

Contractual Obligations

Our contractual obligations as of June 30, 2002 are as follows (in thousands):

	Due in 2003	Due in 2004 and 2005	Due in 2006 and 2007	Due Thereafter	Total
Operating lease obligations	$513	$1,111	$1,171	$2,053	$4,848
Total	$513	$1,111	$1,171	$2,053	$4,848

We believe that our existing cash and cash equivalents and anticipated cash flows from our operating activities 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 expect to 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.

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 is recognized upon shipment of products to our customers. Title and risk of loss transfer to the customer when the product leaves our dock in Simi Valley, California. In general, these customers are allowed to return the product, free of penalty, within 30 days of shipment. After 30 days, customers generally are not allowed to return product to us without a restocking fee. 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 ever returned. Should our experience change, however, we may require additional allowances for sales returns.

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. In addition, if the financial condition of our customers for which we have already established allowances were to improve, then their ability to make payments to us would be less impaired, potentially making such allowances unnecessary.

We write down our inventory for estimated obsolescence 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. Likewise, if technology changes more slowly than expected, or market conditions become more favorable than those projected by management, inventory write-downs may become unnecessary.

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 actively 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.

We do not currently record a valuation allowance to reduce our deferred tax assets because we believe that the assets are more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance, in the event we were to determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

Recent Accounting Pronouncements

In June 2001, the FASB issued SFAS No. 141, "Business Combinations" (SFAS 141), and No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). SFAS 141 requires the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS 141 also includes guidelines on the initial recognition and measurement of goodwill and other intangible assets arising from business combinations completed after June 30, 2001. SFAS 142 prohibits the amortization of goodwill and intangible assets with indefinite useful lives. SFAS 142 requires these assets be reviewed for impairment at least annually. Intangible assets with finite lives will continue to be amortized for their estimated useful lives. We expect to adopt SFAS 142 in the first quarter of fiscal 2003, and do not expect the adoption of the statement to have a significant impact on our financial position or result of operations.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS 144), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," for the disposal of a segment of a business. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, with early application encouraged. We expect to adopt SFAS 144 in the first quarter of fiscal 2003, and do not expect the adoption of the statement to have a significant impact on our financial position or result of operations.

Item 7a. Qualitative and Quanitative 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 short-term instruments. 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

See Index to Financial Statements at page F-1.

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

Not applicable.

PART III

The information called for by Items 10, 11, 12 and 13 of Part III of Form 10-K (except information as to Qualstar's executive officers, which information follows Item 4 in Part I 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, 2002, and is hereby incorporated by reference to such Proxy Statement.

PART IV

Item 15. Exhibits, Financials Statement Schedules and Reports on Form 8-K

(a) (1) The following documents are filed as part of this Report:

Consolidated Financial Statements—See Index to Financial Statements in Item 8 commencing at F-1 of this Report.

(2) Supplemental Schedule:

Schedule II—Valuation and Qualifying Accounts; Allowance for Doubtful Accounts

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) Reports on Form 8-K. No reports on Form 8-K were filed during the last quarter of the fiscal year ended June 30, 2002.

(c) 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.
21.1	Subsidiaries of Qualstar Corporation
23.1	Consent of Ernst & Young LLP, Independent Auditors.
99.1	Certification by Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2	Certification by Chief 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.

* 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(c) of this report.

QUALSTAR CORPORATION

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Shareholders of Qualstar Corporation

We have audited the accompanying consolidated balance sheets of Qualstar Corporation as of June 30, 2001 and 2002, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended June 30, 2002. Our audits also included the financial statement schedule listed at the index in 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 auditing standards generally accepted in the 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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, 2001 and 2002, and the consolidated results of its operations and its cash flows for the three years in the period ended June 30, 2002, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ ERNST & YOUNG LLP

Woodland Hills, California
August 30, 2002

QUALSTAR CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	June 30, 2001	June 30, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$20,809	$16,363
Marketable securities	6,278	14,482
Accounts receivable, net of allowances of $470 in 2001 and $2,100 in 2002	6,379	6,695
Inventories	10,632	9,652
Prepaid expenses and other current assets	400	355
Prepaid income taxes	927	148
Deferred income taxes	1,041	1,501
Total current assets	46,466	49,196
Property and equipment, net	1,126	1,324
Other assets	286	238
Total assets	$47,878	$50,758
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,374	$ 1,590
Accrued payroll and related liabilities	227	308
Other accrued liabilities	483	693
Income taxes payable	—	98
Total current liabilities	3,084	2,689
Deferred income taxes	105	96
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value; 5,000 shares authorized; no shares issued	—	—
Common stock, no par value; 50,000 shares authorized, 12,601 and 12,656 shares issued and outstanding as of June 30, 2001 and 2002, respectively	20,691	20,751
Deferred compensation	(1,061)	(631)
Notes from directors	(512)	(387)
Accumulated other comprehensive income(loss)	60	(31)
Retained earnings	25,511	28,271
Total shareholders' equity	44,689	47,973
Total liabilities and shareholders' equity	$47,878	$50,758

See accompanying notes

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	Years Ended June 30,		
	2000	**2001**	**2002**
Net revenues	$49,352	$51,572	$37,631
Cost of goods sold	30,915	33,216	23,753
Gross profit	18,437	18,356	13,878
Operating expenses:			
Research and development	1,027	1,279	2,136
Sales and marketing	2,643	3,399	3,048
General and administrative	2,057	3,301	5,222
Total operating expenses	5,727	7,979	10,406
Income from operations	12,710	10,377	3,472
Interest income	54	1,225	1,133
Impairment of investment	—	(1,050)	—
Income before provision for income taxes	12,764	10,552	4,605
Provision for income taxes	4,968	3,824	1,845
Net income	$ 7,796	$ 6,728	$ 2,760
Earnings per share:			
Basic	$ 1.10	$ 0.54	$ 0.22
Diluted	$ 0.80	$ 0.53	$ 0.22
Share used to compute earnings per share:			
Basic	7,119	12,372	12,475
Diluted	9,742	12,668	12,664

See accompanying notes

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands)

	Series A Nonredeemable Preferred Stock		Common Stock		Deferred	Notes From	Accumulated Other Comprehensive	Retained	
	Shares	Amount	Shares	Amount	Compensation	Directors	Income	Earnings	Total
Balances at July 1, 1999	881	$ 431	6,656	$ 280	$ (58)	$ —	$—	$10,987	$11,640
Initial public offering, issuance of common stock	—	—	2,500	15,272	—	—	—	—	15,272
Exercise of stock options	—	—	413	114	—	—	—	—	114
Directors' notes	—	—	—	—	—	(600)	—	—	(600)
Sale of restricted stock to directors	—	—	216	600	—	—	—	—	600
Deferred compensation related to stock options and restricted stock	—	—	—	1,703	(1,703)	—	—	—	—
Amortization of deferred compensation	—	—	—	—	227	—	—	—	227
Conversion of preferred stock to common stock	(881)	$(431)	2,379	431	—	—	—		—
Accrued interest on directors' notes	—	—	—	—	—	(17)	—	—	(17)
Net income	—	—	—	—	—	—	—	7,796	7,796
Balances at June 30, 2000	—	—	12,164	18,400	(1,534)	(617)	—	18,783	35,032
Exercise of stock options	—	—	62	43	—	—	—	—	43
Initial public offering, issuance of common stock	—	—	375	2,284	—	—	—	—	2,284
Amortization of deferred compensation	—	—	—	—	437	—	—	—	437
Forfeiture of unvested stock options	—	—	—	(36)	36	—	—	—	—
Accrued interest on directors' notes	—	—	—	—	—	(35)	—	—	(35)
Principal payments on directors' notes	—	—	—	—	—	140	—	—	140
Comprehensive income:									
Net income	—	—	—	—	—	—	—	6,728	6,728
Unrealized gains on investments	—	—	—	—	—	—	60	—	60
Comprehensive income									6,788
Balances at June 30, 2001	—	—	12,601	20,691	(1,061)	(512)	60	25,511	44,689
Exercise of stock options	—	—	55	35	—	—	—	—	35
Amortization of deferred compensation	—	—	—	—	430	—	—	—	430
Settlement of IPO expenses	—	—	—	25	—	—	—	—	25
Accrued interest on directors' notes	—	—	—	—	—	(27)	—	—	(27)
Principal payments on directors' notes	—	—	—	—	—	152	—	—	152
Comprehensive income:									
Net income	—	—	—	—	—	—	—	2,760	2,760
Unrealized losses on investments	—	—	—	—	—	—	(91)	—	(91)
Comprehensive income									2,669
Balances at June 30, 2002	—	$ —	12,656	$20,751	$ (631)	$(387)	$ (31)	$28,271	$47,973

See accompanying notes

QUALSTAR CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Years Ended June 30,		
	2000	**2001**	**2002**
OPERATING ACTIVITIES:			
Net income	$ 7,796	$ 6,728	$ 2,760
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	152	237	272
Deferred income taxes	(235)	(344)	(469)
Provision for bad debts and returns	50	118	1,679
Amortization of deferred compensation	227	437	430
Impairment of investment	—	1,050	—
Accrued interest on directors' notes	(17)	(35)	(27)
Changes in operating assets and liabilities:			
Accounts receivable	(2,411)	779	(1,995)
Inventories	(4,006)	(1,975)	980
Prepaid expenses and other assets	(160)	(455)	93
Prepaid income taxes and income taxes payable	(420)	(162)	877
Accounts payable	1,594	33	(784)
Accrued payroll and related liabilities	26	(166)	81
Other accrued liabilities	3	325	235
Net cash provided by operating activities	2,599	6,570	4,132
INVESTING ACTIVITIES:			
Purchases of equipment and leasehold improvements	(93)	(986)	(470)
Purchase of investments in equity securities	(1,050)	—	—
Purchases of marketable securities	—	(7,233)	(17,231)
Proceeds from the sale of marketable securities	—	1,015	8,936
Net cash used in investing activities	(1,143)	(7,204)	(8,765)
FINANCING ACTIVITIES:			
Principal and interest payments on directors' notes	—	140	152
Proceeds from issuance of common stock, net of offering costs	15,272	2,284	—
Proceeds from exercise of stock options	114	43	35
Net cash provided by financing activities	15,386	2,467	187
NET INCREASE(DECREASE) IN CASH AND CASH EQUIVALENTS	16,842	1,833	(4,446)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	2,134	18,976	20,809
CASH AND CASH EQUIVALENTS, END OF PERIOD	$18,976	$20,809	$ 16,363
SUPPLEMENTAL CASH FLOW DISCLOSURES:			
Income taxes paid	$ 5,619	$ 4,330	$ 1,436

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 high-performance cartridge tape drives, storage arrays of 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 network operating systems, including UNIX, Windows NT, NetWare, and Linux and a wide range of storage management software. Qualstar offers tape libraries for multiple tape drive technologies, including those using Linear Tape Open, Advanced Intelligent Tape, and Digital Linear Tape.

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.

Stock Split and Initial Public Offering

In connection with Qualstar's initial public offering, on March 13, 2000 the Board of Directors approved a 2.7-for-1 stock split of Qualstar's common stock, which became effective March 29, 2000. All references in the accompanying financial statements to the number of shares of common stock and per common share amounts have been retroactively adjusted to reflect the stock split. In addition, Qualstar's capital structure was changed, effective as of March 29, 2000, to reflect 50,000,000 authorized shares of common stock and to authorize an additional 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.

On June 23, 2000 Qualstar commenced its initial public offering. In the offering Qualstar sold 2.5 million shares of common stock at $7.00 per share and received net proceeds of $15.3 million. In July 2000, Qualstar sold an additional 375,000 shares of common stock resulting in proceeds of $2.4 million, net of underwriters' commission, as a result of the underwriters' exercising their over-allotment provisions of the underwriting agreement. All outstanding Series A Preferred Stock automatically converted into common stock on June 28, 2000 at a ratio of 2.7-for-1, resulting in the issuance of 2.4 million shares of common stock.

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 insignificant risk of changes in value because of 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 uncollectable accounts have been provided for in the financial statements.

Sales to customers located outside of the United States represented 25.8% of net revenues in 2000, 26.9% of net revenues in 2001, and 32.2% of net revenues in 2002. Revenues from Qualstar's two largest customers were 33.2%, 29.2%, and 17.6% for the years ended June 30, 2000, 2001, and 2002, respectively. At June 30, 2001 and 2002 the two largest customer's accounts receivable, net of specific allowances, totaled 19.3% and 8.5% of total accounts receivable, respectively.

Marketable Securities

Marketable securities consist primarily of high-quality U.S. corporate securities and U.S. government federal, state and municipal 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, 2001 and 2002.

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.

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 48.0% and 59.7%, respectively, of total sales and cost of goods sold for the year ended June 30, 2000. Sales and costs of goods sold related to products purchased from one supplier totaled approximately 45.4% and 57.6%, respectively, of total sales and cost of goods sold for the year ended June 30, 2001. Sales and costs of goods sold related to products purchased from one large supplier totaled approximately 55.1% and 43.7%, respectively, of total sales and cost of goods sold for the year ended June 30, 2002.

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.

Investment in Common Stock

In November 1999, Qualstar purchased an approximate 1% interest in Chaparral Network Storage, Inc. (Chaparral) for an aggregate purchase price of $1,050,000. This investment is accounted for under the cost method. Chaparral designs and manufactures RAID controllers and intelligent storage routers for tape library applications.

During the fourth quarter of fiscal year 2001, management determined the carrying value of the investment in Chaparral exceeded its net realizable value as a result of rapid changes in technology and the availability of capital for further development of its family of products. Accordingly, management determined an allowance in the amount of $1,050,000 was necessary to reduce the carrying value of the investment in Chaparral to its estimated net realizable value. The related charge is included in the statement of income as an impairment of investment.

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. Qualstar has identified no impairment losses of long-lived assets 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 outbound shipping and fulfillment costs are classified as costs of goods sold.

Warranty Costs

Qualstar generally provides warranties for its products ranging from one to three years. With respect to drives and tapes used in Qualstar's products, but manufactured by a third party, Qualstar passes on to the customer the warranty on such drives and tapes provided by the manufacturer. A provision for costs related to warranty expense is recorded when revenue is recognized, which is estimated based on historical warranty costs incurred.

Research and Development

All research and development costs are charged to expense as incurred. These costs consist primarily of engineering salaries, outside consultant fees, prototype materials and applicable overhead expenses 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, 2000, 2001 and 2002 were $470,000, $426,000 and $211,000, 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 the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation" (SFAS 123).

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 carrying amounts and the tax bases of assets and liabilities.

Comprehensive Income

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

Earnings Per Share

Qualstar calculates earnings per share in accordance with SFAS No. 128, "Earnings per Share." Basic earnings per share has been computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share has been computed by dividing net income 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,		
	2000	2001	2002
	(in thousands)		
Earnings:			
Net income	$7,796	$ 6,728	$ 2,760
Shares:			
Weighted average shares for basic earnings per share	7,119	12,372	12,475
Conversion of Series A Preferred Stock	2,376	—	—
Stock options	247	296	189
Weighted average shares for diluted earnings per share	9,742	12,668	12,664

Shares issuable under stock options of 68,000 at June 30, 2001 and 2002 have been excluded from the computation of diluted earnings 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.

Recent Accounting Pronouncements

In June 2001, the FASB issued SFAS No. 141, "Business Combinations" (SFAS 141), and No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). SFAS 141 requires the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS 141 also includes guidelines on the initial recognition and measurement of goodwill and other intangible assets arising from business combinations completed after June 30, 2001. SFAS 142 prohibits the amortization of goodwill and intangible assets with indefinite useful lives. SFAS 142 requires these assets be reviewed for impairment at least annually. Intangible assets with finite lives will continue to be amortized for their estimated useful lives. The Company expects to adopt SFAS 142 in the first quarter of fiscal 2003, and does not expect the adoption of the statement to have a significant impact on the Company's financial position or result of operations.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS 144), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," for the disposal of a segment of a business. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, with early application encouraged. The Company expects to adopt SFAS 144 in the first quarter of fiscal 2003, and does not expect the adoption of the statement to have a significant impact on the Company's financial position or result of operations.

Reclassification

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

2. Inventories

Inventories consist of the following (*in thousands*):

	June 30, 2001	June 30, 2002
Raw materials	$ 9,001	$7,980
Finished goods	1,631	1,672
	$10,632	$9,652

3. Property and Equipment

The components of property and equipment are as follows (*in thousands*):

	June 30, 2001	June 30, 2002
Leasehold improvements	$ 535	$ 541
Furniture and fixtures	725	907
Machinery and equipment	1,768	2,050
	3,028	3,498
Less accumulated depreciation and amortization	(1,902)	(2,174)
	$ 1,126	$ 1,324

4. Income Taxes

The provision for income taxes is comprised of the following (*in thousands*):

	Year Ended June 30, 2000	2001	2002
Current:			
Federal	$4,171	$3,414	$1,775
State	1,032	754	539
	5,203	4,168	2,314
Deferred:			
Federal	(207)	(256)	(391)
State	(28)	(88)	(78)
	(235)	(344)	(469)
	$4,968	$3,824	$1,845

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

	Year Ended June 30,		
	2000	2001	2002
Statutory federal income tax expense	34.0%	34.0%	34.0%
State income taxes, net of federal income tax benefit	4.9	4.3	4.5
Other	—	(2.1)	1.6
	38.9%	36.2%	40.1%

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

	June 30,	
	2001	2002
Deferred tax assets:		
Allowance for bad debts and returns	$ 201	$ 861
Reserve for Chaparral investment	450	430
Capitalized inventory costs	42	31
State income taxes	264	140
Other accruals	84	39
Total deferred tax assets	1,041	1,501
Deferred tax liability:		
Depreciation	(105)	(96)
	$ 936	$1,405

No valuation reserve was established at June 30, 2001 and 2002, based on Qualstar's expectations to be able to realize the benefit from the deferred tax asset.

5. Series A Preferred Stock

At June 30, 1999, 880,800 shares of preferred stock had been issued as Series A Preferred Stock. Each share of Series A Preferred Stock was convertible into 2.7 shares of common stock and the outstanding shares of Series A preferred stock automatically converted into a total of 2.4 million shares of common stock upon completion of Qualstar's initial public offering.

6. Stock Option Plans

Qualstar adopted a stock option plan in 1985 under which incentive stock options and nonqualified stock options could be granted for an aggregate of no more than 1,350,000 shares of common stock. Under the terms of the plan, incentive stock options and nonqualified options could be issued at an exercise price of not less than 100% and 85%, respectively, of the fair market value of common stock as determined by the board of directors on the date of grant. Options are exercisable in annual installments as specified in each stock option agreement. Incentive stock options and nonqualified stock options terminate as specified in each option agreement, but no later than ten years after the date of grant unless an extension is granted by the board of directors. The stock option plan expired on March 27, 1995. No new shares may be granted under the plan after that date; however, outstanding stock options may be exercised in accordance with their terms.

Qualstar adopted a new stock option plan in 1998 (1998 Stock Incentive Plan) under which incentive and nonqualified stock options could be granted for an aggregate of no more than 270,000 shares of common stock. During fiscal 2000, Qualstar amended and restated the 1998 stock option plan to increase the pool of options and shares of restricted stock that 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 (*in thousands, except per share amounts*):

	Stock Options	Exercise Price Per Share	Weighted Average Exercise Price
Outstanding at July 1, 1999	562	0.22 – 1.11	0.34
Granted	137	2.78	2.78
Exercised	(413)	0.22 – 0.56	0.28
Outstanding at June 30, 2000	286	0.22 – 2.78	1.60
Granted	84	9.38	9.38
Exercised	(62)	0.22 – 2.78	0.68
Cancelled	(52)	0.56 – 9.38	3.46
Outstanding at June 30, 2001	256	0.22 – 9.38	4.00
Granted	248	4.37 – 5.94	5.21
Exercised	(55)	0.22 – 2.78	0.63
Cancelled	(8)	2.78	2.78
Outstanding at June 30, 2002	441	0.22 – 9.38	5.12

	Options Outstanding at June 30, 2002			Options Exercisable at June 30, 2002	
Exercise Price Range	Number of Shares Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Shares Exercisable	Weighted Average Exercise Price
$0.56	8	5.8	0.56	8	0.56
$2.78	117	7.5	2.78	55	2.78
$4.37 – 5.94	248	9.4	5.21	—	—
$9.38	68	8.1	9.38	17	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 accrues at the rate of 6.21% and is payable annually. Payments of principal on the notes are due in four equal annual installments beginning in January 2002. Qualstar, solely at its discretion, has 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 lapses and the shares vest ratably over four years based upon each year of service as a director.

On January 14, 2000, Qualstar granted stock options to purchase a total of 137,700 shares under the 1998 Stock Incentive Plan at an exercise price of $2.78 per share. These stock options vest over a four year period.

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 the option and restricted stock awards 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 is being amortized over the four-year vesting period, which resulted in compensation expense of $227,000 in fiscal 2000, $437,000 in fiscal 2001, and $430,000 in fiscal 2002.

If Qualstar recognized employee stock option-related compensation expense in accordance with SFAS 123 and used the minimum value method for grants prior to Qualstar's initial public offering and the Black-Scholes model afterward for determining the weighted average fair value of options granted during 2000, 2001 and 2002, its pro forma net income would have been $7.8 million, $6.6 million, and $2.6 million, respectively. The pro forma basic income per share would have been $1.09, $0.53, and $0.21 for 2000, 2001, and 2002, respectively. The pro forma diluted income per share would have been $0.80, $0.52, and $0.21 for 2000, 2001 and 2002, respectively. 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 for 2000, 2001 and 2002 is not representative of the pro forma effect on net income or loss in future years because compensation expense in future years will 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 $5.59 for 2000, $5.88 for 2001, and $1.97 for 2002 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.

	2000	2001	2002
Expected dividend yield	0%	0%	0%
Risk-free interest rate	6.5%	6.5%	4.5%
Expected life of options	5 years	5 years	5 years
Volatility	—	69.0%	38.0%

7. Commitments

During fiscal year 2001, Qualstar entered into a new lease agreement for a facility located in Simi Valley, California. The lease agreement 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.

During fiscal year 2002, Qualstar entered into a new lease agreement for a facility located in Boulder, Colorado. The lease agreement expires in May of 2007 with an initial annual rent in the amount of $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
2003	$ 513,000
2004	549,000
2005	562,000
2006	581,000
2007	590,000
Thereafter	2,053,000
	$4,848,000

Rent expense (including equipment rental) for the years ended June 30, 2000, 2001, and 2002, was $209,000, 366,000 and $594,000, respectively.

Qualstar may be involved in litigation and other legal matters from time to time in the normal course of business. However, there currently are no material proceedings pending or, to the knowledge of management, threatened against Qualstar.

8. Geographic Information

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

	Year Ended June 30,		
	2000	2001	2002
Revenues:			
North America	$37,789	$37,700	$25,550
Europe	7,594	9,850	9,811
Asia	3,642	3,754	1,758
Other	327	268	512
	$49,352	$51,572	$37,631

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

9. 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 90 days of employment and may contribute up to 15% of their compensation. Qualstar may make matching contributions at a rate of 25% up to 6% of the amount contributed by eligible participants at the discretion of management. Qualstar's contributions under the Plan totaled $33,000, $44,000 and $51,000 for the years ended June 30, 2000, 2001 and 2002, respectively.

10. Related Party Transactions

Qualstar's outside counsel became a member of its board of directors, in January 2000. During the year ended June 30, 2001, Qualstar paid $175,000 to the law firm in which the director is a shareholder, of which $70,000 related to the initial public offering with the remainder for general business purposes. During the year ended June 30, 2002, Qualstar paid $132,000 for general business purposes to the law firm in which the director is a shareholder.

11. Quarterly Results of Operations (unaudited)

	Three Months Ended			
	September 30,	December 31,	March 31,	June 30,
	(in thousands, except per share amounts)			
Fiscal 2001:				
Net sales	$13,853	$15,510	$11,106	$11,103
Gross profit	5,121	5,745	3,710	3,780
Net income	2,313	2,298	1,345	772
Net earnings per share:				
Basic	$ 0.19	$ 0.19	$ 0.11	$ 0.06
Diluted	0.18	0.18	0.11	0.06
Fiscal 2002:				
Net sales	$ 8,797	$10,031	$ 8,603	$10,200
Gross profit	3,330	3,798	3,191	3,559
Net income(loss)	1,167	1,208	695	(310)
Net earnings(loss) per share:				
Basic	$ 0.09	$ 0.10	$ 0.06	$ (0.02)
Diluted	0.09	0.10	0.05	(0.02)

As discussed in Note 1 to these financial statements, net income during the fourth quarter of fiscal year 2001 was adversely affected due to a $1,050,000 reserve established by management to reduce the carrying value of the investment in Chaparral to zero. Net income during the fourth quarter of fiscal 2002 was adversely affected by an increase in the bad debt reserve of $1,600,000, primarily with respect to one customer.

12. Subsequent Events

Subsequent to year end, Qualstar acquired the assets and intellectual properties of N2Power, Incorporated, a privately held company which designs and produces small and efficient open-frame switching power supplies. The consideration for this acquisition amounted to $250,000 which has been paid in cash. The acquisition will be accounted for using the purchase method of accounting, and accordingly, the acquired assets will be recorded at their estimated fair values.

SCHEDULE II

QUALSTAR CORPORATION

VALUATION AND QUALIFYING ACCOUNTS
ALLOWANCE FOR DOUBTFUL ACCOUNTS
For the Years Ended June 30, 2000, 2001, and 2002

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, 2000	$420,000	$ 152,000	$—	$102,000	$ 470,000
Year Ended June 30, 2001	470,000	118,000	—	118,000	470,000
Year Ended June 30, 2002	$470,000	$1,679,000	$—	$ 49,000	$2,100,000

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

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.

Date: September 27, 2002

QUALSTAR CORPORATION

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 27, 2002
/s/ RICHARD A. NELSON Richard A. Nelson	Vice President, Engineering Secretary and Director	September 27, 2002
/s/ MATTHEW NATALIZIO Matthew Natalizio	Vice President and Chief Financial Officer (principal financial and accounting officer)	September 27, 2002
/s/ BRUCE E. GLADSTONE Bruce E. Gladstone	Director	September 27, 2002
/s/ TRUDE C. TAYLOR Trude C. Taylor	Director	September 27, 2002
/s/ ROBERT E. RICH Robert E. Rich	Director	September 27, 2002
/s/ ROBERT T. WEBBER Robert T. Webber	Director	September 27, 2002

QUALSTAR CORPORATION

CORPORATE AND SHAREHOLDER INFORMATION

BOARD OF DIRECTORS

William J. Gervais
Chief Executive Officer and
President of Qualstar Corporation

Richard A. Nelson
Vice President of Engineering and
Secretary of Qualstar Corporation

Bruce Gladstone
Executive Vice President,
2K Sounds, Inc.

Robert E. Rich
Attorney,
Stradling Yocca Carlson & Rauth

Trude Taylor
Principal, TC Associates,
a private investment firm

Robert T. Webber
Private Investor

EXECUTIVE OFFICERS

William J. Gervais
Chief Executive Officer, President

Richard A. Nelson
Vice President of Engineering
and Secretary

Frederic T. Boyer*
Vice President and Chief Financial Officer

David L. Griffith
Vice President of Operations

Robert K. Covey
Vice President of Marketing

Mark R. Gilmore
Vice President of Sales

Tim Studebaker
Vice President of Advanced Development

LEGAL COUNSEL

Stradling Yocca Carlson & Rauth
Newport Beach, California

INDEPENDENT AUDITORS

Ernst & Young LLP
Woodland Hills, California

REGISTRAR AND TRANSFER AGENT

Shareholders with questions about transferring stock, replacing lost or stolen certificates or other matters related to stock ownership should contact:

Corporate Stock Transfer, Inc.
3200 Cherry Creek Drive South
Suite 430
Denver, CO 80209
303-282-4800

MARKET INFORMATION

Nasdaq National Market
Symbol: QBAK

INVESTOR RELATIONS

Frederic T. Boyer
805-583-7744

WEBSITE ADDRESS

www.qualstar.com

ANNUAL MEETING

The annual meeting of shareholders will be held at the Grand Vista Hotel, 999 Enchanted Way, Simi Valley, CA 93065 on Thursday, February 6, 2003 at 9:00 a.m.

*Mr. Boyer joined Qualstar on Oct 24, 2002.

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