QUANTUM CORPORATION ANNUAL REPORT 1986

"Our goal at Quantum is to continue to define innovative products for our customers, bring them to market quickly, and maintain excellence in conducting our business."

CORPORATE PROFILE

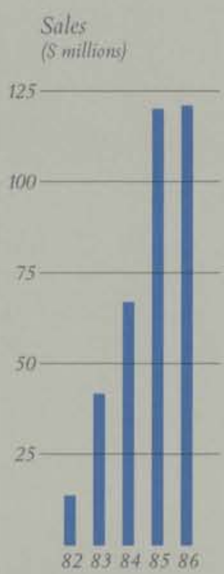
Quantum Corporation develops, manufactures and markets rigid disk drives and subsystems for computer systems.

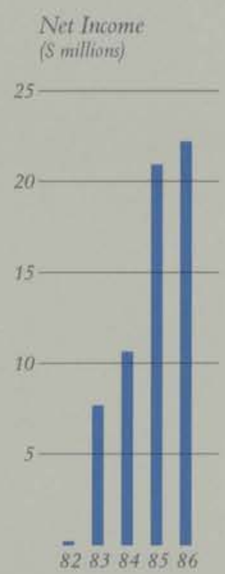
Quantum's products include a new series of half-high, 5¼-inch high-capacity subsystems, and 5¼-inch and 8-inch Winchester disk drives. They are sold to original equipment manufacturers (OEMs) for use in professional and engineering workstations; multi-user, micro-processor-based business computer systems; and applications such as computer graphics and local area networks.

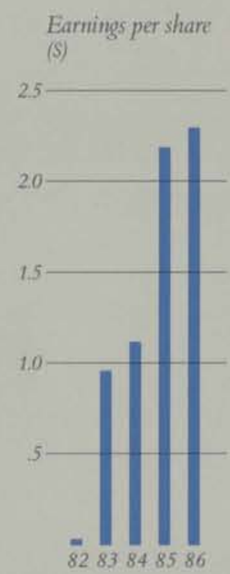
Plus Development Corporation, Quantum's subsidiary, developed Hardcard,™ the first hard disk expansion board for personal computers. Hardcard is available with 10 megabytes of capacity, and a 20 megabyte version is scheduled for introduction during the first quarter of fiscal 1987. It is distributed through computer retail stores and value-added resellers (VARs). Established in 1980, Quantum employs approximately 700 people. Headquarters are located in Milpitas, California, with manufacturing facilities in Milpitas and Ponce, Puerto Rico. Plus was incorporated in 1983 and maintains headquarters in Milpitas.

FINANCIAL HIGHLIGHTS

For the fiscal years ended March 31 (Thousands except per share and employee amounts)	1986	1985	1984	1983	1982
Sales	$121,244	$120,349	$67,069	$41,779	$13,656
Net income	22,243	20,973	10,673	7,838	186
Income per share:					
Income before extraordinary credit	2.30	2.19	1.12	.86	.03
Net income	2.30	2.19	1.12	.96	.03
Number of employees	696	771	628	291	262
Working capital	94,064	71,599	32,697	25,599	1,785
Total assets	126,162	99,526	74,816	56,630	12,121
Shareholders' equity	105,812	82,481	60,311	48,489	4,167







Fiscal 1986 was a significant year for Quantum as we began to see the results of innovation in our products. We completed the development of a major new disk drive product for the original equipment manufacturer (OEM) market and began shipping evaluation units to customers. We expect to begin production using our innovative, new manufacturing process during the first quarter of fiscal year 1987. Our subsidiary, Plus Development Corporation, introduced a unique new product for the retail/end-user market, achieving volume production before the end of the year. We also completed the transfer of one of Quantum's earlier product lines to our facility in Puerto Rico.

Revenue for the fiscal year was $121,244,000 compared to $120,349,000 in 1985. Net income was $22,243,000, a slight increase over $20,973,000 last year, and earnings per share rose to $2.30 from $2.19 in 1985. Sales were basically flat compared to last year primarily because of the reduced demand for Quantum's mature products, the Q2000 Series® 8-inch disk drive products, and the Q500 Series® 5¼-inch products. In response to this situation, we took steps to reduce the cost of our products by reducing the amount of labor required to produce them and improving yields.

Our balance sheet is strong. Quantum recorded a positive cash flow during the year of $30 million. We received $6 million from Computer Memories, Inc., (CMI) in settlement of patent litigation. Additionally, inventory levels were reduced from $23 million to $15 million. During the year, we completed the transfer of the Q500 product to Quantum Caribe in Puerto Rico. Both the Q500 and the Q2000 now are being manufactured there. We believe that sales of these products have reached a plateau and will continue to decline as our customers move to new product designs using disk drives like Quantum's new Q200 Series.™

The Q200 is an advanced subsystem series and we are in the fortunate position of being the first to market this type of product. It represents a major advancement in disk drive architecture by combining all elements of drive performance and control in a single, half-high 5¼-inch package. Q200 Series products have formatted capacities of 53 and 80 megabytes, include an integrated disk drive controller, and have an average access time of less than 30 milliseconds. Evaluation units were shipped in the fourth quarter of the fiscal year with production scheduled for the first quarter of fiscal 1987.

Developing the Q200 Series was a sizeable task involving the application of technology that was new to us. As a result, our original product introduction schedule slipped. However, we have made technical adjustments and anticipate rapid ramp up of the product in fiscal 1987.

Quantum's semiautomated manufacturing line is an excellent example of our innovation and provides us with important advantages for the Q200 and future products. It was designed around a goal of 100 percent yields, a major factor in controlling product costs, and it will enable us to ramp up quickly to high volume production to meet market demand.

We were pleased with the performance of Plus Development Corporation, Quantum's subsidiary that we established for our diversification into the retail/end-user marketplace. Plus successfully launched Hardcard™ and built a solid market leadership position. Hardcard is a 10-megabyte hard disk drive subsystem on a plug-in card for IBM® PCs and PC-compatible computers. Hardcard is an innovative product that uses proven Winchester technologies and can be installed easily by any user into a single expansion slot.

During the year, Plus established a distribution network including the top 25 computer specialty store chains in the United States, representing more than 1,800 outlets nationwide. We established a relationship with a national distributor, MicroAmerica, to reach the next tier of 2,000 dealers and value-added resellers (VARs). Toward the end of the year, we expanded distribution into Canada, England, France and Germany. We began manufacturing with our partner, Matsushita Kotobuki Electronics Ltd. (MKE) in Japan, achieving all objectives for cost, quality and availability.

Additionally, Hardcard was recognized by the industry as an entirely new class of product, an accomplishment underscored by its being named the 1985 Product of the Year by four industry publications. Competition in this market is intense, but our position in retail and distribution channels is strong, and we believe our product is superior in its ease of installation into a single expansion slot, its software support, quality, reliability, availability and suitability for its particular application.

Perhaps most importantly, by the close of the fiscal year, Plus had built an organization capable of sustaining solid growth through fiscal 1987. Quantum is entering the coming fiscal year in a good position. The disk drive industry is stronger than it was a year ago. There is continuing demand for higher capacity, high performance and lower cost disk drives, a demand driven by development of higher performance computer systems. The majority of our customers are anticipating growth in the coming year, an expectation that applies to both our OEM and end user businesses.

We plan to start shipping the Q160 product, our new 160-megabyte, full-height 5¼-inch system, in the third fiscal quarter. The rapid introduction of this new member of the Q200 Series is possible because it takes advantage of the technological innovations made on the original Q200 products and because it will use the same manufacturing process. In addition, Plus will introduce a 20-megabyte configuration Hardcard product. This product will offer the end user a higher-performance product with double the capacity of the original Hardcard product, which like the 10 megabyte product, will fit into one expansion slot. We intend to continue developing innovative products for our markets, to bring these products to market quickly, and to maintain our excellence in running our businesses efficiently and profitably. We are prepared to accomplish these goals in the coming years just as we have accomplished our goals in the past.

James L. Patterson
President and
Chief Executive Officer

At Quantum, we believe that innovation must pervade all aspects of a company's business to enable it to achieve success and profitability. This is especially true in the disk drive industry. In this constantly changing environment, the ability to perceive, understand, and rapidly respond to change requires innovation.

Quantum's success relates to the innovation we have used to create unique products, bring them to market quickly, and produce them profitably.

Today, Quantum operates two businesses: our original business produces rigid disk drives for original equipment manufacturers (OEMs) and our subsidiary, Plus Development Corporation, develops rigid disk drives for end users. In this annual report, we would like to tell you how we have used innovation in both businesses.

Teamwork is fundamental to Quantum's new product development efforts. From left; Tony Lo, product manager; John Tomlin, manager of Q200 manufacturing operations; Rich Watkins, manager, testing and development; and Harvey Tom, manager of production; are part of the team that took the Q200 product from conception through its market introduction in fiscal 1986.

When Quantum was founded, there were two prevailing approaches to designing Winchester disk drives for the OEM. We combined the best of both and designed a unique positioning control system for the read/write heads. Quantum's patented wedge servo architecture uses an optical encoder to position the head over the desired track of information. A "wedge" of information recorded on one disk in each drive provides data to center the head over the track and maintain precise positioning. This system formed the basis for the Q2000 Series® and Q500 Series® — the first disk drives to combine low cost and manufacturability with high capacity and performance.

For our new Q200 Series,™ changing demands in our industry led us to design a product that is different in several significant ways from our previous products. In place of the wedge servo approach, the Q200 Series uses an embedded servo positioning control scheme, eliminating the need for an optical encoder to position the head. The controller was integrated into the drive to improve manufacturing yields, and the actuator was made smaller and faster. The Q200 products cost approximately the same as our earlier products, but offer greater storage capacity, smaller size and higher performance.

In recent years, there has been an increasing trend toward selling disk drive products directly to end users. In response to this trend, we created a subsidiary, Plus Development Corporation, to develop and distribute disk drives to the retail market. Plus introduced Hardcard,™ the first hard disk expansion board for personal computers. Hardcard transformed the traditional hard disk drive, with its separate controller and cables, into a compact device that is easily installed by any user into a single expansion slot in a PC. Hardcard uses the same optical encoder and actuator electronics as Quantum's original OEM products, but has an advanced head-positioning system to reduce size and a built in controller to increase reliability.

New products this year were Hardcard™ hard-disk expansion board from Plus, top, and the Q200 Series™ intelligent drive from Quantum.

Quantum's new manufacturing line for the Q200 product produces nearly twice the number of drives per shift as earlier production lines in less than half the space with about one-third the labor. Steve Campbell, engineer, from left; Pat Weiher, engineering manager; and Ted Sunada, industrial engineer; were key members of the Q200 team.

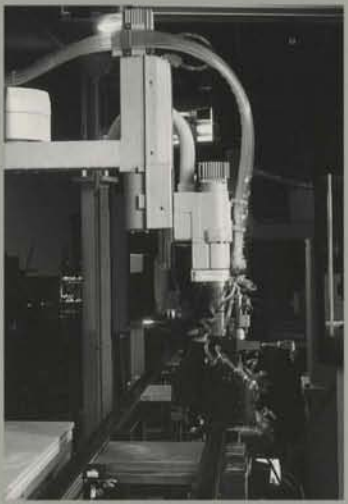
Quantum consistently has placed equal importance on the design and the manufacturability of its products. When we designed Quantum's original OEM products — the Q2000 and Q500 — we simultaneously designed or specified the manufacturing process, the tools and the test equipment. We developed a manufacturing line made up of modular workstations, which enabled us to add capacity as product demand increased, as opposed to requiring a large capital expenditure up front.

As Quantum began development of the Q200, we realized the disk drive industry was becoming an increasingly competitive, worldwide market encompassing stronger competitors than we had seen in previous product generations. In order to compete with these world-class manufacturers, Quantum established a goal of 100 percent process yields, recognizing that the lowest possible product cost can only be achieved with exceptionally high yields.

In addition to developing a new product concept in the Q200, we changed our fundamental approach to manufacturing. We developed a state-of-the-art, semiautomated manufacturing line that requires less than 10,000 square feet of space to produce 900 Q200 Series disk drives during an eight-hour shift — one drive every 30 seconds. By comparison, the Q500 requires twice the space to produce about half the number of drives per shift.

When we decided to enter the consumer market, we recognized that the demands of this market were entirely different from those of OEM customers.

The key to success in this market is the ability to bring your product to market quickly, in the quantities the market demands. Rather than spending time and money to develop economical, high volume manufacturing capabilities to produce the Hardcard ourselves, we departed from our past approach to manufacturing and decided to produce the Hardcard in Japan through a manufacturing agreement with Matsushita Kotobuki Electronic Industries, Ltd. MKE is an experienced Japanese manufacturer and a leader in sophisticated manufacturing processes.



Robots assist in final assembly of Q200 drives, top. Head disk assemblies are manufactured on a semiautomated production line.

Vital to success for both Quantum and Plus is a clear understanding of market segmentation strategy. Helping to define our strategy are Quantum's Bob Peyton, director of business planning, top left; and Rolf Brauchler, director of marketing; and below from left, Plus executives Dave Brown, vice president of operations; Steve Berkley, president; and Hank Chesbrough, product manager.

Quantum's strategy since the beginning of the company has derived from a clear understanding of the disk drive market. When we started, small disk drives were sold almost exclusively through OEM channels. Our customers wanted products that would be reliable and would be delivered as promised. Our approach was to take available technology, apply innovation and market understanding, and then develop products with the right price and performance combination to fit market needs.

For the OEM market, Quantum's strategy is to continue to bring to the OEM marketplace innovative products that meet customers' needs. We work to understand how mass storage *could* be used as well as how it is *being* used. We concentrate on three objectives: defining distinctive products that have real and measurable value to our customers and which are feasible from a technical and business standpoint, developing these products faster than our competitors, and maximizing our long-term profit from ongoing businesses.

In the end-user market, our understanding of the disk drive market and our analysis of the needs for new products led us to recognize that a number of changes in our industry were occurring. We established Plus Development Corporation to address the very different requirements and distribution channels of the new mass storage add-in market. Plus' strategy is to focus initially on market opportunities associated with the sizeable installed base of IBM® Personal Computers. To accomplish this, Plus built a strong marketing and sales organization to establish name awareness for Plus and brand awareness for its products. Plus' long-range plan is to use this foundation for introducing new PC enhancement products that will be sold through the same distribution channels.

Quantum Caribe in Puerto Rico produces the Q2000 and Q500 products. Above from left are Heriberto Perez, product specialist; Zulma Burgos, production manager; and Migdalia Morales, drive reworker (top); and Wilson Santiago, assembler.

Teamwork characterizes management at Quantum. Pam Kenady, engineering manager, top right; and Mellie Leal, assembler; discuss a manufacturing issue. Below are management team members Joe Shepela, vice president, human resources; Joe Rodgers, executive vice president, finance; Richard Taylor, vice president, manufacturing; and Art Geffon, vice president, engineering.

Quantum has always recognized that our people are our one unique asset and our most valuable resource. We believe developing this asset requires innovation in managing people.

At Quantum, we value our people and let them know they are valued. We communicate the importance of each individual's contributions to our success. We seek out the opinions of our people, and work as a team to make sure we get the best results. We also have made a major effort to be certain that our people know and understand the purpose and values we have adopted as a company.

Our management approach is reflected in the way we work. For example, to develop the Q200, we set up a team with each member responsible for a certain function but with all members involved in major decisions that cut across functional lines.

We believe it is important to manage our company so that our people continue to have challenges and opportunities for expanding their skills.

Accordingly, we structured Plus as an entrepreneurial company, to help us retain and continue to attract outstanding people by providing a working environment that allows them to share directly in the results of their efforts. Similarly, we have structured Quantum based on teams that develop ideas for new products and stay with their projects to completion.

Our achievements over the years clearly demonstrate what our people can accomplish. From the introduction of our first disk drive to our newest subsystems, Quantum has been recognized as a leader in our industry. That success has come from good people continually working as a team to bring innovation to all areas of our business.

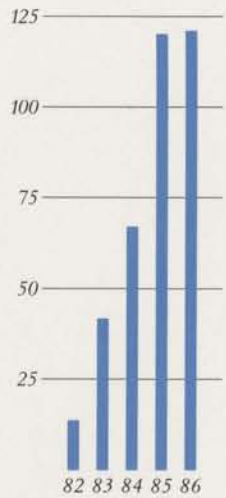
Jim Watson, vice president, marketing and sales; and Jim Parson, Q200 project manager; planned the Q200 market introduction.

SELECTED FINANCIAL INFORMATION

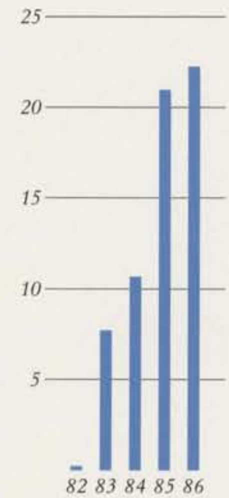
Five years ended March 31, 1986

(Thousands except per share amounts and number of employees)	1986	1985	1984	1983	1982
Net sales	$121,244	$120,349	$67,069	$41,779	$13,656
Income before extraordinary credit	$ 22,243	$ 20,973	$10,673	$ 7,024	$ 186
Net income	$ 22,243	$ 20,973	$10,673	$ 7,838	$ 186
Earnings per share:					
Income before extraordinary credit	$ 2.30	$ 2.19	$ 1.12	$ .86	$ .03
Net income	$ 2.30	$ 2.19	$ 1.12	$ .96	$ .03
Common and common equivalent shares	9,673	9,589	9,516	8,172	6,595
Total assets	$126,162	$ 99,526	$74,816	$56,630	$12,121
Shareholders' equity	$105,812	$ 82,481	$60,311	$48,489	$ 4,167
Backlog	$ 22,422	$ 32,608	$43,947	$14,250	$13,000
Number of employees	696	771	628	291	262
Net sales per employee	$ 161	$ 172	$ 155	$ 154	$ 96

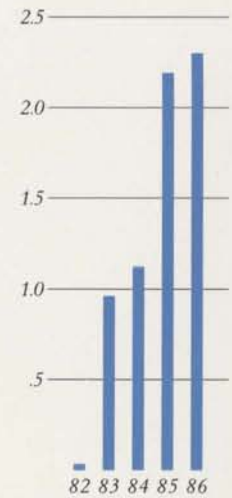
Sales
($ millions)



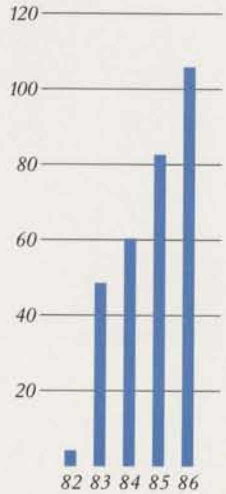
Net Income
($ millions)



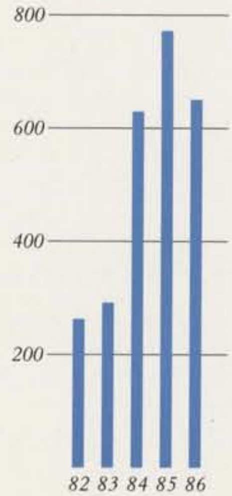
Earnings per share
($)



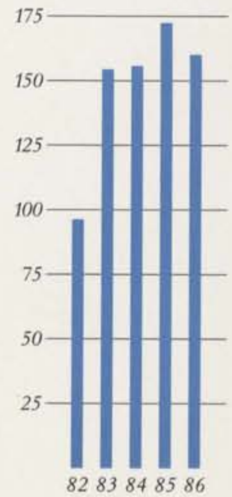
Shareholders' equity
($ millions)



Number of employees



Sales per employee
($ thousands)



MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

Sales for the fiscal year ended March 31, 1986, were $121.2 million as compared with sales of $120.3 million in the prior year. For continuing products, sales declined in each quarter. Sales of the Q2000 Series® 8-inch products decreased by 33% from the prior year as customers gradually phased out the product. Sales of the Q500 Series® 5¼-inch product increased by 10% during the year, but the average sales price of the product decreased by 6%. The Company expects the demand for both of these products to continue to decline and prices to erode over the next fiscal year. Offsetting the sales decline in continuing products were sales generated by the new product, Hardcard,™ which was developed by the Company's subsidiary, Plus Development Corporation. Sales of the Hardcard, a card-mounted mass-storage subsystem for personal computers that is marketed through retail channels, represented 11% of revenue in the current year.

In fiscal year 1986, the overall gross profit percentage remained constant at approximately 40%. Material costs of the existing products were less than in the prior year as the cost of certain components declined. Manufacturing overhead costs for the Q2000 and Q500 Series products decreased slightly as the Company transferred the Q500 Series 5¼-inch products to Puerto Rico. The transfer is now complete and in the next fiscal year all Q2000 and Q500 Series products will be manufactured in Puerto Rico. As a result of the transfer and the fact that future products of the Company will be less labor intensive, the Company reduced its workforce in California by approximately 80 people in March 1986. Manufacturing overhead costs related to the Hardcard are low as the product is manufactured by a subcontractor in Japan. Because of these factors, the overall gross profit percentage did not drop despite a decline in sales prices. The overall effect of inflation on the cost of materials, labor and other expenses was minimal.

Research and development expenses increased substantially over the prior year as the Company continued development efforts on several new products. The Company has substantially completed the development of the Q200 Series,™ a new generation of half-height 5¼-inch disk drives. The Company also started the development of a new full-height 5¼-inch disk drive with 160 megabyte capacity for the OEM market. In addition, Quantum's subsidiary, Plus Development Corporation, completed the development of the Hardcard in September 1985 and started the development of a low cost 20 megabyte disk drive as a follow-up product.

Marketing expenses increased significantly from $5.4 million in fiscal 1985 to $10.7 million in fiscal 1986. This increase is primarily due to higher advertising expenses associated with the promotion of new products and costs associated with the development of the retail distribution channels for the Hardcard.

General and administrative costs decreased slightly compared with the prior year. The decrease is mainly attributable to lower litigation costs related to the patent infringement suit filed by the Company against Computer Memories, Inc., (CMI) which was settled in January 1986.

Interest and investment income increased from $3.1 million in fiscal 1985 to $4.3 million in fiscal 1986. The increase was attributable to higher cash and cash equivalent balances maintained during fiscal 1986.

In January 1986, Quantum reached a settlement agreement in its action against Computer Memories, Inc., for violation of Quantum's patent. As a result of the court settlement, Quantum received $6 million from CMI, which was fully taken into income during fiscal 1986.

Quantum's effective tax rate of 30% was less than the prior year's effective tax rate of 32%. This rate differed from the federal tax rate of 46% mainly as a result of the reduced tax rate on income generated by Quantum Caribe, the Company's subsidiary in Puerto Rico.

At March 31, 1986, the Company had working capital of $94 million, which included cash and cash equivalents of approximately $78 million. The significant increase in working capital over the prior year was mainly attributable to a positive cash flow from operations as well as additional cash received on the settlement of the CMI litigation. The Company believes that its working capital is adequate to meet its future needs.

	Percentage of Net Sales				
Year ended March 31	1986	1985	1984	1983	1982
Sales	100.0%	100.0%	100.0%	100.0%	100.0%
Costs and expenses					
Cost of sales	60.1	61.2	61.3	56.2	75.8
Research and development	9.3	6.0	4.7	5.8	3.1
Marketing	8.8	4.5	6.0	6.4	13.2
General and administrative	4.0	4.4	4.4	3.2	6.3
Total costs and expenses	82.2	76.1	76.4	71.6	98.4
Income from operations	17.8	23.9	23.6	28.4	1.6
Interest and net realization on marketable investment securities	3.6	1.6	5.1	2.4	(.2)
Income from litigation settlement	4.9				
Income before income taxes	26.3	25.5	28.7	30.8	1.4
Provision for income taxes	7.9	8.1	12.8	14.0	
Income before extraordinary credit	18.4	17.4	15.9	16.8	1.4
Extraordinary credit				2.0	
Net income	18.4%	17.4%	15.9%	18.8%	1.4%

CONSOLIDATED STATEMENTS OF OPERATIONS

Year ended March 31	1986	1985	1984
Sales	$121,244,000	$120,349,000	$67,069,000
Costs and expenses:			
Cost of sales	72,868,000	73,668,000	41,131,000
Research and development	11,298,000	7,210,000	3,156,000
Marketing	10,653,000	5,397,000	4,044,000
General and administrative	4,897,000	5,265,000	2,948,000
	99,716,000	91,540,000	51,279,000
Income from operations	21,528,000	28,809,000	15,790,000
Interest and dividend income (expense), net	4,315,000	3,098,000	3,433,000
Income from litigation settlement (Note 11)	6,000,000		
Loss on sale of marketable securities (Note 5)		(1,245,000)	
Income before income taxes	31,843,000	30,662,000	19,223,000
Provision for income taxes (Note 9)	9,600,000	9,689,000	8,550,000
Net income	$ 22,243,000	$ 20,973,000	$10,673,000
Net income per common share (Note 1)	$2.30	$2.19	$1.12
Common and common equivalents used in computing per share amounts	9,672,573	9,589,114	9,516,211

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

March 31	1986	1985
Assets		
Current assets:		
Cash, including certificates of deposit of $63,317,000 and $45,338,000	$ 67,767,000	$46,966,000
Cash, restricted certificates of deposit (Note 10)	10,250,000	
Accounts receivable, net of allowance for doubtful accounts of $898,000 and $617,000	11,688,000	13,407,000
Interest and dividends receivable	223,000	298,000
Inventories (Notes 1 and 3)	15,178,000	23,014,000
Prepaid income taxes (Note 9)	1,385,000	960,000
Prepaid expenses	224,000	212,000
Other current assets	474,000	720,000
Total current assets	107,189,000	85,577,000
Property and equipment at cost less accumulated depreciation (Note 4)	18,508,000	13,513,000
Other assets	465,000	436,000
	$126,162,000	$99,526,000
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 8,824,000	$ 9,076,000
Accrued compensation	1,391,000	1,167,000
Income taxes payable	324,000	1,583,000
Accrued warranty expense	1,537,000	1,523,000
Other accrued liabilities	1,049,000	629,000
Total current liabilities	13,125,000	13,978,000
Deferred income taxes (Note 9)	7,225,000	3,067,000
Commitments (Note 10)		
Shareholders' equity (Notes 6, 7, and 8):		
Preferred stock, no par value, 4,000,000 shares authorized, none issued		
Common stock, no par value, 30,000,000 shares authorized, 9,462,694 and 9,363,985 shares outstanding	45,668,000	44,580,000
Retained earnings	60,144,000	37,901,000
Total shareholders' equity	105,812,000	82,481,000
	$126,162,000	$99,526,000

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year ended March 31	1986	1985	1984
Financial resources were provided by:				
	Operations:			
	Net income	$22,243,000	$20,973,000	$10,673,000
	Charges not affecting working capital			
	—depreciation	3,603,000	2,433,000	1,333,000
	—deferred taxes	4,158,000	2,372,000	366,000
	—write-down of marketable investment securities		456,000	720,000
	—loss on marketable investment securities		1,245,000	
	Resources provided by operations	30,004,000	27,479,000	13,092,000
	Proceeds from sales of marketable securities		17,480,000	
	Common stock transactions	1,088,000	747,000	424,000
		31,092,000	45,706,000	13,516,000
Financial resources were used for:				
	Acquisition of property and equipment, net of retirements	8,598,000	6,762,000	6,327,000
	Other assets	29,000	42,000	91,000
		8,627,000	6,804,000	6,418,000
	Increase in working capital	$22,465,000	$38,902,000	$ 7,098,000
Increase (decrease) in components of working capital:				
	Cash	$20,801,000	$28,294,000	$(2,164,000)
	Cash, restricted	10,250,000		
	Accounts receivable	(1,719,000)	4,225,000	3,323,000
	Interest and dividends receivable	(75,000)	(377,000)	196,000
	Inventories	(7,836,000)	5,337,000	11,660,000
	Prepaid income taxes	425,000	960,000	
	Prepaid expenses	12,000	4,000	7,000
	Other current assets	(246,000)	627,000	74,000
	Accounts payable	252,000	803,000	(7,707,000)
	Accrued compensation	(224,000)	(303,000)	(365,000)
	Income taxes payable	1,259,000	(43,000)	2,273,000
	Deferred income taxes		315,000	573,000
	Accrued warranty expenses	(14,000)	(615,000)	(579,000)
	Other accrued liabilities	(420,000)	(325,000)	(193,000)
	Increase in working capital	$22,465,000	$38,902,000	$ 7,098,000

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Stock (Notes 6, 7, and 8) Shares	Amount	Valuation allowance for marketable investment securities	Retained earnings	Total
Balance at March 31, 1983	9,151,839	$43,409,000	$(1,175,000)	$ 6,255,000	$ 48,489,000
Shares repurchased under employee stock purchase agreements (Note 6)	(867)	(2,000)			(2,000)
Shares issued under employee stock option plan (Note 7)	71,904	91,000			91,000
Shares issued under employee stock purchase plan (Note 8)	17,647	299,000			299,000
Shares issued as an employee stock bonus	2,085	36,000			36,000
Reduction of valuation allowance for marketable investment securities			725,000		725,000
Net income for year ended March 31, 1984				10,673,000	10,673,000
Balance at March 31, 1984	9,242,608	$43,833,000	$ (450,000)	$16,928,000	$ 60,311,000
Shares repurchased from employees	(1,680)	(46,000)			(46,000)
Shares issued under employee stock option plan (Note 7)	92,063	309,000			309,000
Shares issued under employee stock purchase plan (Note 8)	30,994	484,000			484,000
Valuation allowance for marketable investment securities			450,000		450,000
Net income for year ended March 31, 1985				20,973,000	20,973,000
Balance at March 31, 1985	9,363,985	$44,580,000		$37,901,000	$ 82,481,000
Shares repurchased under employee stock purchase agreements (Note 6)	(3,034)	(1,000)			(1,000)
Shares repurchased from employees	(1,822)	(45,000)			(45,000)
Shares issued under employee stock option plan (Note 7)	70,739	299,000			299,000
Shares issued under employee stock purchase plan (Note 8)	32,826	532,000			532,000
Tax benefits related to stock option plans		303,000			303,000
Net income for year ended March 31, 1986				22,243,000	22,243,000
Balance at March 31, 1986	9,462,694	$45,668,000		$60,144,000	$105,812,000

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Significant accounting policies

Quantum Corporation (the Company) has adopted accounting practices which are generally accepted in the industry in which it operates. The following are the Company's significant accounting policies.

Principles of consolidation

The accompanying consolidated financial statements include the accounts of Quantum Corporation and its wholly owned and majority owned subsidiaries. All significant transactions and accounts between the Company and these subsidiaries have been eliminated in consolidation.

Revenue recognition

Revenue from sales of products is recognized upon shipment to customers.

Research and development expenses

Research and development expenditures are expensed when incurred.

Warranty expenses

The Company generally warrants its products against defect for one year. A provision for estimated future costs relating to warranty expenses is recorded when products are shipped.

Inventories

Inventories are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or market.

Property and equipment and depreciation

Property and equipment are stated at cost. Depreciation is computed for financial reporting purposes using the straight-line method and the estimated useful lives which range from three to ten years. Amortization of leasehold improvements is computed over the shorter of the useful life of the improvement or the life of the lease. Depreciation for income tax purposes is computed using accelerated methods.

Forward exchange contracts

The Company enters into forward exchange contracts to reduce the risk of foreign currency fluctuations on certain inventory purchase commitments. Such contracts are designated as a hedge of the foreign currency commitments. Accordingly, the effects of the contracts are reflected in the valuation of the related inventories.

Income taxes

Investment and research and development tax credits are recognized as a reduction of income tax expense in the year the related assets are placed in service or the qualified research and development expenditures are incurred to the extent of the statutory limits applied to pre-tax accounting income.

Net income per common share

Primary net income per common and common equivalent share is computed on the weighted average number of common shares and common equivalent shares from options outstanding during the respective periods, using the treasury stock method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2—Business segment

The Company is engaged in a single business segment consisting of the design, manufacture and marketing of disk drives based on Winchester technology. The Company supplies high-capacity disk drives to original equipment manufacturers ("OEMs") for use in small business computers, word processors and intelligent terminals. In addition, Quantum's majority-owned subsidiary, Plus Development Corporation, designs and markets personal-computer enhancement products to end-users.

Foreign sales account for 20%, 21%, and 16% of total sales in 1986, 1985, and 1984, respectively. Major customers (those accounting for 10% or more of sales) accounted for 17%, 13%, 12%, and 11% of revenues during the year ended March 31, 1986, 16%, 14%, 11%, and 10% of revenues during the year ended March 31, 1985 and 15%, 10%, 10%, and 10% of revenues for the year ended March 31, 1984.

Sales of Plus Development Corporation represented 11% of consolidated sales for the year ended March 31, 1986, the first year in which the subsidiary shipped its product. The stockholders' deficit of Plus Development Corporation, which does not reflect the tax benefit of operating losses incurred, amounted to $9,220,000 at March 31, 1986. Officers and employees of the parent company and of Plus Development hold a minority interest in that subsidiary which amounted to 17% of the voting stock of the subsidiary at that date.

Note 3—Inventories

Inventories were composed of:

March 31	1986	1985
Materials and purchased parts	$ 5,775,000	$11,887,000
Work in process	2,308,000	5,912,000
Finished goods	7,095,000	5,215,000
	$15,178,000	$23,014,000

Note 4—Property and equipment

Property and equipment consisted of:

March 31	1986	1985
Machinery and equipment	$15,980,000	$10,629,000
Furniture and fixtures	1,910,000	1,594,000
Tooling	3,219,000	3,200,000
Leasehold improvements	3,603,000	2,287,000
Construction in progress	1,867,000	305,000
	26,579,000	18,015,000
Less-accumulated depreciation	(8,071,000)	(4,502,000)
	$18,508,000	$13,513,000

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 — Marketable investment securities

During fiscal 1983 the Company invested approximately $20 million in adjustable rate preferred stock purchased at a premium of $2,784,000 above par value. During the period that the Company held the investment, a valuation allowance was included in shareholders' equity to the extent an excess of cost over market was considered a temporary decline in value. The amount considered to be a permanent impairment of value was charged to income. For federal income tax purposes, 85% of the dividends received on these securities are exempt from tax. During fiscal 1985, these securities were sold at a loss of $1,245,000.

Note 6 — Stock purchase agreements

Under the terms of stock purchase agreements, shares were sold to employees at prices determined by the Board of Directors. Shares acquired under terms of these agreements vest on a graduated basis over five years. During this period, the employee may not sell or dispose of the unvested stock. If employment is terminated for any reason other than death or disability during this period, the Company retains the right to repurchase the unvested shares at the original purchase price. In addition, the Company has the first right to repurchase all shares acquired under the plan at a price determined by the terms set forth in the plan.

In January 1982, under a common stock purchase agreement, the Company sold 24,000 common shares to a non-employee director at $.375 per share, in consideration for his participation on the Board. Shares issued under this agreement have subsequently vested.

During the year ended March 31, 1982 and the period from February 20, 1980 (inception) through March 31, 1981, 340,000 and 1,761,000 shares of common stock, respectively, were sold to employees under the agreements. During fiscal 1986, 1985 and 1984, 3,034, 0 and 867 shares, respectively, were reacquired by the Company.

Note 7 — Stock option plan

In September 1981, the Company adopted the 1981 Incentive Stock Option Plan. Under this plan, 850,000 shares of common stock were reserved for issuance to eligible employees. Options under the plan are granted at prices determined by the Board of Directors, but not less than the fair market value, as determined by the Board, on the date of grant and expire five years after the date of grant. Generally, one-fifth of the grant becomes exercisable after the first year following the grant, and at one-sixtieth per month thereafter. At March 31, 1986 and 1985, options with respect to 24,800 shares and 99,400 shares, respectively, of common stock were available for grant.

In November 1984, the Company adopted the 1984 Incentive Stock Option Plan, and reserved 300,000 shares of common stock for issuance to eligible employees and consultants of the Company. The terms of this plan are essentially identical to those of the 1981 Incentive Stock Option Plan. At March 31, 1986 and 1985, options with respect to 231,600 and 300,000 shares, respectively, of common stock were available for grant.

A summary of transactions relating to outstanding stock options follows:

Year ended March 31	1986		1985	
	Shares	Option Price	Shares	Option Price
Options outstanding beginning of period	570,600	$ .19 - 30.25	470,800	$ .19 - 31.88
Options granted	203,800	18.75 - 21.25	224,700	17.00 - 20.00
Options cancelled	(56,600)	.38 - 31.88	(32,800)	.38 - 30.25
Options exercised	(74,400)	.19 - 22.00	(92,100)	.19 - 22.00
Options outstanding end of period	643,400	$ .19 - 31.88	570,600	$ .19 - 31.88
Options exercisable end of period	134,000		41,500	

Note 8—Employee Stock Purchase Plan

In November 1982, the Board of Directors approved the adoption of an Employee Stock Purchase Plan (the "Purchase Plan") and reserved 100,000 shares of common stock for purchase by eligible employees at the lower of 85% of the fair market value of the common stock at the beginning or at the end of each six month offering period. The Purchase Plan permits eligible employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee's compensation.

During fiscal 1986 and 1985, 32,826 and 30,994 shares were issued under this plan.

Note 9—Income taxes

The components for the provision for income taxes are presented below.

Year ended March 31	1986	1985	1984
Current —Federal	$2,568,000	$5,468,000	$6,812,000
—State	3,299,000	3,124,000	1,945,000
Deferred—Federal	3,775,000	1,111,000	(125,000)
—State	(42,000)	(14,000)	(82,000)
Total provision for income taxes	$9,600,000	$9,689,000	$8,550,000

Deferred (prepaid) income taxes represent the tax effect of transactions which are reported in different periods for financial and tax reporting purposes.

The sources of deferred (prepaid) income taxes and the income tax effect of each are as follows:

Year ended March 31	1986	1985	1984
Reversal of deferred profit on installment sales	$ (322,000)	$ (419,000)	$ 116,000
Excess of tax over book depreciation	855,000	486,000	366,000
Taxable portion of DISC income not currently deductible		(63,000)	172,000
Inventory valuation allowances	(392,000)	(135,000)	(673,000)
Accrued warranty expense	(27,000)	(191,000)	(269,000)
Deferred tax on income from Puerto Rico operations	3,401,000	1,545,000	102,000
Other	218,000	(126,000)	(21,000)
	$3,733,000	$1,097,000	$(207,000)

As a result of the provisions of the "Deficit Reduction Act of 1984," the Company's Domestic International Sales Corporation (DISC) terminated on December 31, 1984, and income taxes on accumulated earnings were permanently forgiven. Since it had been the intention of the Company to reinvest indefinitely the earnings of its DISC, income taxes had not previously been provided on the accumulated DISC earnings. Accordingly, this change in the DISC rules had no effect on net earnings.

Note 9 — Income taxes — continued

The Company's effective income tax rate for the years ended March 31, 1986, March 31, 1985, and March 31, 1984, varies from the 46% statutory federal rate for the following reasons:

Year ended March 31	1986		1985		1984	
Taxes computed at the statutory rate	$14,648,000	46.0%	$14,105,000	46.0%	$8,843,000	46.0%
State income tax, net of federal benefit	1,324,000	4.2	1,292,000	4.2	1,005,000	5.2
Investment tax credits (net of recapture)	(504,000)	(1.6)	(298,000)	(1.0)	(302,000)	(1.5)
Research and development tax credits	(635,000)	(2.0)	(590,000)	(1.9)		
Dividend exclusion			(372,000)	(1.2)	(762,000)	(4.0)
Non-deductible loss on stock			572,000	1.8		
Reduced tax rate of Puerto Rican operations	(5,090,000)	(16.0)	(5,189,000)	(16.9)	(332,000)	(1.7)
Foreign Sales Corporation	(46,000)	(0.2)				
Other	(97,000)	(0.3)	169,000	0.6	98,000	0.5
Provision for income taxes	$ 9,600,000	30.1%	$ 9,689,000	31.6%	$8,550,000	44.5%

Note 10 — Commitments

At March 31, 1986, the Company is contingently liable for outstanding letters of credit totalling $8,000,000, which are secured by certificates of deposit. The Company is also required to maintain certificates of deposit, totalling $2,250,000 at March 31, 1986, to secure certain outstanding forward exchange currency contracts.

The Company leases its present facilities and certain equipment under non-cancellable operating lease agreements that range from 5 to 10 years. Some of the leases have renewal options ranging from 5 to 10 years.

Equipment is leased through a bank for a five-year term expiring in 1986. This lease agreement requires, among other things, the Company to maintain certain financial covenants including specified minimum current ratio, working capital, tangible net worth and cash position levels and a maximum debt to tangible net worth ratio.

Rent expense charged to income is as follows:

Year ended March 31	1986	1985	1984
Rental expense	$2,211,000	$1,912,000	$1,546,000
Sub-lease rental income	(265,000)	(282,000)	(235,000)
Net rental expense	$1,946,000	$1,630,000	$1,311,000

Future minimum lease payments under operating leases are as follows:

Year ended March 31	
1987	$2,132,000
1988	1,238,000
1989	920,000
1990	920,000
1991	920,000
Thereafter	578,000
Total future minimum lease payments	6,708,000
Future minimum sub-lease income	(18,000)
Net future minimum lease payments	$6,690,000

Note 11—Litigation settlement

During January 1986, the Company settled a patent infringement suit that it brought against Computer Memories, Inc. (CMI). The terms of the settlement resulted in a cash payment to the Company of $6,000,000 and a stipulated injunction restricting CMI from the development, manufacture and sale of its patent infringing products as of April 30, 1986.

Note 12—Unaudited quarterly consolidated financial data

1986	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Net sales	$34,001,000	$29,084,000	$30,473,000	$27,686,000	$121,244,000
Gross profit	13,344,000	10,780,000	13,207,000	11,045,000	48,376,000
Net income	5,743,000	4,394,000	5,220,000	6,886,000	22,243,000
Earnings per share	$.60	$.45	$.54	$.71	$2.30
1985					
Net sales	$25,377,000	$30,085,000	$31,798,000	$33,089,000	$120,349,000
Gross profit	9,015,000	11,268,000	12,979,000	13,419,000	46,681,000
Net income	4,271,000	4,687,000	5,949,000	6,066,000	20,973,000
Earnings per share	$.45	$.49	$.62	$.63	$2.19

REPORT OF INDEPENDENT ACCOUNTANTS

To the Shareholders and
Board of Directors of
Quantum Corporation

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of shareholders' equity and of changes in financial position present fairly the financial position of Quantum Corporation and its subsidiaries at March 31, 1986 and 1985, and the results of their operations and the changes in their financial position for each of the three years in the period ended March 31, 1986, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Price Waterhouse

San Jose, California
May 2, 1986

COMMON STOCK TRADING RANGE

Quantum Corporation's common stock has been traded in the over-the-counter market under the NASDAQ symbol QNTM since the Company's initial public offering on December 10, 1982. The price per share reflected in the table represents the range of high and low closing prices in the NASDAQ National Market System for the quarter indicated.

Fiscal 1986	High	Low
Fourth quarter ended March 31, 1986	27	21¼
Third quarter ended December 29, 1985	27¼	19¾
Second quarter ended September 29, 1985	28¼	21
First quarter ended June 30, 1985	24¼	18¾
Fiscal 1985		
Fourth quarter ended March 31, 1985	30	20
Third quarter ended December 29, 1984	21¾	17¼
Second quarter ended September 29, 1984	22¾	16¾
First quarter ended June 30, 1984	21¼	16½

The Company has not paid cash dividends on its common stock and does not plan to pay cash dividends to its shareholders in the near future. The Company presently intends to retain its earnings to finance future growth of its business.

As of June 3, 1986, there were approximately 6,100 shareholders of the Company.

BOARD OF DIRECTORS

Frank J. Caufield
General Partner, Kleiner Perkins, Caufield & Byers (Venture capital investments)

Glenn M. Mueller
General Partner, Mayfield Fund (Venture capital investments)

James L. Patterson
President and Chief Executive Officer, Quantum Corporation

Robert E. Schroeder
President and Chief Executive Officer, International Power Technology (Supplier of gas turbine based co-generation systems)

OFFICERS

James L. Patterson
President and Chief Executive Officer

David B. Pratt
Senior Vice President and Chief Operating Officer

Arthur P. Geffon
Vice President, Engineering

Joseph Shepela
Vice President, Human Resources

Joseph T. Rodgers, Jr.
Executive Vice President, Finance Secretary and Treasurer

Richard P. Taylor
Vice President, Manufacturing

James G. Watson
Vice President, Marketing

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A copy of the Company's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission, is available from the Company without charge. Please direct your request to:

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Secretary and Treasurer
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Milpitas, CA 95035**

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Independent Accountants
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San Jose, CA 95113

Transfer Agent
Bank of America
P.O. Box 37002
San Francisco, CA 94137

The Annual Meeting of Shareholders of Quantum Corporation will be held at 3:00 p.m. on August 20, 1986, at Quantum Corporation 1804 McCarthy Boulevard, Milpitas, CA 95035.

Designed and Produced by Torme Design
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Written by Fenimore & Associates

Quantum

Quantum Corporation
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Milpitas, CA 95035

Dave Brown