

NAPCO SECURITY TECHNOLOGIES, INC  
Form 10-Q  
February 10, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

X QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE  
ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED: DECEMBER 31, 2013  
OR  
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE  
ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.

Commission File number: 0-10004

NAPCO SECURITY TECHNOLOGIES, INC.  
(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation of  
organization)

11-2277818  
(IRS Employer Identification  
Number)

333 Bayview Avenue  
Amityville, New York  
(Address of principal  
executive offices)

11701  
(Zip Code)

(631) 842-9400  
(Registrant's telephone number including area code)

(Former name, former address and former fiscal year if  
changed from last report)

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 and Exchange Act of 1934 during the preceding 12 months (or 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 X No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during

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the preceding 12 months (or such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act:

L a r g e	Accelerated	Non-Accelerated	Smaller reporting
A c c e l e r a t e d	Filer	Filer	company
Filer			<input checked="" type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

Yes No

Number of shares outstanding of each of the issuer’s classes of common stock, as of: February 10, 2014

COMMON STOCK, \$.01 PAR VALUE PER SHARE 19,408,276

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NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

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## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2013 (unaudited)	June 30, 2013 (audited)
	(in thousands, except for share data)	
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 3,379	\$ 3,229
Accounts receivable, net of reserves and allowances	13,704	18,211
Inventories	19,788	18,471
Prepaid expenses and other current assets	1,369	1,219
Income tax receivable	--	64
Deferred income taxes	681	642
Total Current Assets	38,921	41,836
Inventories - non-current	3,226	3,436
Deferred income taxes	1,541	1,526
Property, plant and equipment, net	6,512	6,586
Intangible assets, net	9,943	10,334
Other assets	179	185
<b>TOTAL ASSETS</b>	<b>\$ 60,322</b>	<b>\$ 63,903</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Current maturities of long term debt	\$ 1,600	\$ 1,600
Accounts payable	3,030	3,318
Accrued expenses	1,857	2,093
Accrued salaries and wages	1,597	1,604
Accrued income taxes	22	--
Total Current Liabilities	8,106	8,615
Long-term debt, net of current maturities	11,500	14,800
Accrued income taxes	164	153
Total Liabilities	19,770	23,568
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Common Stock, par value \$0.01 per share; 40,000,000 shares authorized; 21,038,443 and 20,796,813 shares issued; and 19,408,276 and 19,296,335 shares outstanding, respectively	210	208
Additional paid-in capital	15,818	15,356
Retained earnings	32,568	32,078
	48,596	47,642
Less: Treasury Stock, at cost (1,630,167 and 1,500,478 shares, respectively)	(8,044 )	(7,307 )

TOTAL STOCKHOLDERS' EQUITY	40,552	40,335
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 60,322	\$ 63,903

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

	Three months ended December 31,	
	2013	2012
	(In thousands, except share and per share data)	
Net sales	\$ 18,353	\$ 17,212
Cost of sales	13,272	12,571
Gross Profit	5,081	4,641
Selling, general, and administrative expenses	4,547	4,287
Operating Income	534	354
Other expense:		
Interest expense, net	110	141
Other, net	4	4
Income before Income Taxes	420	209
Income tax expense	52	74
Net Income	\$ 368	\$ 135
Net Income per share:		
Basic	\$ 0.02	\$ 0.01
Diluted	\$ 0.02	\$ 0.01
Weighted average number of shares outstanding:		
Basic	19,408,000	19,154,000
Diluted	19,444,000	19,496,000

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

	Six months ended December 31,	
	2013	2012
	(In thousands, except share and per share data)	
Net sales	\$ 35,592	\$ 32,428
Cost of sales	25,472	23,651
Gross Profit	10,120	8,777
Selling, general, and administrative expenses	9,324	8,822
Operating Income (Loss)	796	(45 )
Other expense:		
Interest expense, net	231	318
Other, net	7	7
Income (loss) before Income Taxes	558	(370 )
Income tax expense (benefit)	67	(71 )
Net Income (Loss)	\$ 491	\$ (299 )
Net Income (Loss) per share:		
Basic	\$ 0.03	\$ (0.02 )
Diluted	\$ 0.03	\$ (0.02 )
Weighted average number of shares outstanding:		
Basic	19,366,000	19,125,000
Diluted	19,393,000	19,125,000

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Six months ended December 31,	
	2013	2012
	(in thousands)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income (Loss)	\$ 491	\$ (299 )
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	837	974
Provision for doubtful accounts	10	20
Change in inventory obsolescence reserve	125	--
Deferred income taxes	(54 )	71
Stock based compensation expense	7	--
Changes in operating assets and liabilities:		
Accounts receivable	4,497	2,500
Inventories	(1,232 )	56
Prepaid expenses and other current assets	(150 )	(81 )
Income tax receivable	64	(214 )
Other assets	--	19
Accounts payable and accrued expenses	(499 )	(51 )
Net Cash Provided by Operating Activities	4,096	2,995
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property, plant, and equipment	(366 )	(224 )
Net Cash Used in Investing Activities	(366 )	(224 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Principal payments on long-term debt	(3,300 )	(3,057 )
Cash paid for purchase of treasury stock	(285 )	(435 )
Proceeds from exercise of stock options	5	--
Tax benefit from stock option exercise	--	119
Net Cash Used in Financing Activities	(3,580 )	(3,373 )
Net Increase (Decrease) in Cash and Cash Equivalents	150	(602 )
CASH AND CASH EQUIVALENTS - Beginning	3,229	2,979
CASH AND CASH EQUIVALENTS - Ending	\$ 3,379	\$ 2,377
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>		
Interest paid, net	\$ 240	\$ 242
Income taxes paid	\$ 24	31
<b>NON-CASH FINANCING ACTIVITIES:</b>		
Shares surrendered and held in treasury for common stock options exercised	\$ 28	\$ 1,257
Shares surrendered and cancelled for shares for common stock options exercised	\$ 424	\$ --



See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)  
DECEMBER 31, 2013

NOTE 1 - Nature of Business and Summary of Significant Accounting Policies

Nature of Business:

Napco Security Technologies, Inc. and Subsidiaries (the "Company") is a diversified manufacturer of security products, encompassing electronic door-locking devices, intrusion and fire alarms and building access control systems. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment.

The Company's fiscal year begins on July 1 and ends on June 30. Historically, the end users of the Company's products want to install its products prior to the summer; therefore sales of its products historically peak in the period April 1 through June 30, the Company's fiscal fourth quarter, and are reduced in the period July 1 through September 30, the Company's fiscal first quarter. In addition, demand is affected by the housing and construction markets.

Significant Accounting Policies:

Basis of Presentation

The unaudited condensed consolidated financial statements of Napco Security Technologies, Inc and Subsidiaries (the "Company"), including these notes, have been prepared by the Company in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and pursuant to the rules and regulations promulgated by the U.S. Securities and Exchange Commission (the "SEC"). Accordingly, certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been omitted or condensed. However, in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended June 30, 2013 and the notes thereto included in the Company's Annual Report on Form 10-K filed with the SEC on September 17, 2013. Results of consolidated operations for the interim periods are not necessarily indicative of a full year's operating results. The unaudited condensed consolidated financial statements herein include the accounts of the Company and its wholly owned subsidiaries. All material inter-company accounts and transactions have been eliminated.

Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent gains and losses at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Critical estimates include management's judgments associated with revenue recognition, reserves for sales returns and allowances, concentration of credit risk, inventories, intangible assets and income taxes. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The methods and assumptions used to estimate the fair value of the following classes of financial instruments were:  
Current Assets and Current Liabilities: The carrying amount of cash, certificates of deposits, current receivables and payables and certain other short-term financial instruments approximate their fair value as of December 31, 2013 due to their short-term maturities; Long-Term Debt: The carrying amount of the Company's long-term debt, including the current portion, at December 31, 2013 in the amount of \$13,100,000 approximates fair value.

#### Cash and Cash Equivalents

Cash and cash equivalents include approximately \$460,000 of short-term time deposits at December 31, 2013 and June 30, 2013. The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. The Company has cash balances in banks in excess of the maximum amount insured by the FDIC and other international agencies as of December 31, 2013 and June 30, 2013. The Company has historically not experienced any credit losses with balances in excess of FDIC limits.

#### Accounts Receivable

Accounts receivable is stated net of the reserves for doubtful accounts of \$230,000 and \$220,000 and for returns and other allowances of \$870,000 and \$1,055,000 as of December 31, 2013 and June 30, 2013, respectively. Our reserves for doubtful accounts and for returns and other allowances are subjective critical estimates that have a direct impact on reported net earnings. These reserves are based upon the evaluation of accounts receivable agings, specific exposures, sales levels and historical trends.

#### Inventories

Inventories are valued at the lower of cost or fair market value, with cost being determined on the first-in, first-out (FIFO) method. The reported net value of inventory includes finished saleable products, work-in-process and raw materials that will be sold or used in future periods. Inventory costs include raw materials, direct labor and overhead. The Company's overhead expenses are applied based, in part, upon estimates of the proportion of those expenses that are related to procuring and storing raw materials as compared to the manufacture and assembly of finished products. These proportions, the method of their application, and the resulting overhead included in ending inventory, are based in part on subjective estimates and actual results could differ from those estimates.

In addition, the Company records an inventory obsolescence reserve, which represents any excess of the cost of the inventory over its estimated market value, based on various product sales projections. This reserve is calculated using an estimated obsolescence percentage applied to the inventory based on age, historical trends, requirements to support forecasted sales, and the ability to find alternate applications of its raw materials and to convert finished product into alternate versions of the same product to better match customer demand. In addition, and as necessary, the Company may establish specific reserves for future known or anticipated events. There is inherent professional judgment and subjectivity made by both production and engineering members of management in determining the estimated obsolescence percentage.

The Company also regularly reviews the period over which its inventories will be converted to sales. Any inventories expected to convert to sales beyond 12 months from the balance sheet date are classified as non-current.

#### Property, Plant, and Equipment

Property, plant, and equipment are carried at cost less accumulated depreciation. Expenditures for maintenance and repairs are charged to expense as incurred; costs of major renewals and improvements are capitalized. At the time property and equipment are retired or otherwise disposed of, the cost and accumulated depreciation are eliminated from the asset and accumulated depreciation accounts and the profit or loss on such disposition is reflected in income.

Depreciation is recorded over the estimated service lives of the related assets using primarily the straight-line method. Amortization of leasehold improvements is calculated by using the straight-line method over the estimated useful life of the asset or lease term, whichever is shorter.

#### Intangible Assets

Intangible assets determined to have indefinite lives are not amortized but are tested for impairment at least annually. Intangible assets with definite lives are amortized over their useful lives. Intangible assets are reviewed for impairment at least annually at the Company's fiscal year end of June 30 or more often whenever there is an indication that the carrying amount may not be recovered.

The Company's acquisition of substantially all of the assets and certain liabilities of G. Marks Hardware Inc. ("Marks USA") in August 2008 included intangible assets recorded at fair value on the date of acquisition. The intangible assets are amortized over their estimated useful lives of twenty years (customer relationships) and seven years (non-compete agreement). The Marks USA trade name was deemed to have an indefinite life.

Changes in intangible assets are as follows (in thousands):

	December 31, 2013			June 30, 2013		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Customer relationships	\$ 9,800	\$ (5,836 )	\$ 3,964	\$ 9,800	\$ (5,469 )	\$ 4,331
Non-compete agreement	340	(261 )	79	340	(237 )	103
Trade name	5,900	--	5,900	5,900	--	5,900
	\$ 16,040	\$ (6,097 )	\$ 9,943	\$ 16,040	\$ (5,706 )	\$ 10,334

Amortization expense for intangible assets subject to amortization was approximately \$195,000 and \$229,000 for the three months ended December 31, 2013 and 2012, respectively. Amortization expense for intangible assets subject to amortization was approximately \$391,000 and \$459,000 for the six months ended December 31, 2013 and 2012, respectively. Amortization expense for each of the next five fiscal years is estimated to be as follows: 2014 - \$781,000; 2015 - \$667,000; 2016 - \$529,000; 2017 - \$441,000 and 2018 - \$371,000. The weighted average amortization period for intangible assets was 14.4 years and 15.3 years at December 31, 2013 and 2012, respectively.

#### Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets in question may not be recoverable. Impairment would be recorded in circumstances where undiscounted cash flows expected to be generated by an asset are less than the carrying value of that asset.

#### Revenue Recognition

The Company recognizes revenue when the following criteria are met: (i) persuasive evidence of an agreement exists, (ii) there is a fixed and determinable price for the Company's product, (iii) shipment and passage of title occurs, and (iv) collectability is reasonably assured. Revenues from product sales are recorded at the time the product is shipped or delivered to the customer pursuant to the terms of the sale. The Company reports its sales on a net sales basis, with net sales being computed by deducting from gross sales the amount of actual sales returns and other allowances and the amount of reserves established for anticipated sales returns and other allowances.

#### Sales Returns and Other Allowances

The Company analyzes sales returns and is able to make reasonable and reliable estimates of product returns based on the Company's past history. Estimates for sales returns are based on several factors including actual returns and based on expected return data communicated to it by its customers. Accordingly, the Company believes that its historical returns analysis is an accurate basis for its allowance for sales returns. Actual results could differ from those estimates.

#### Advertising and Promotional Costs

Advertising and promotional costs are included in "Selling, General and Administrative" expenses in the consolidated statements of operations and are expensed as incurred. Advertising expense for the three months ended December 31, 2013 and 2012 was \$247,000 and \$294,000, respectively. Advertising expense for the six months ended December 31, 2013 and 2012 was \$612,000 and \$721,000, respectively.

#### Research and Development Costs

Research and development costs incurred by the Company are charged to expense in the year incurred and are included in "Cost of Sales" in the consolidated statements of operations. Company-sponsored research and development expense for the three months ended December 31, 2013 and 2012 was \$1,252,000 and \$1,319,000, respectively. Company-sponsored research and development expense for the six months ended December 31, 2013 and 2012 was \$2,538,000 and \$2,655,000, respectively.

#### Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the

years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income tax expense represents the change during the period in the deferred tax assets and deferred tax liabilities. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company measures and recognizes the tax implications of positions taken or expected to be taken in its tax returns on an ongoing basis.

#### Net Income (Loss) Per Share

Basic net income (loss) per common share (Basic EPS) is computed by dividing net income by the weighted average number of common shares outstanding. Diluted net income (loss) per common share (Diluted EPS) is computed by dividing net income by the weighted average number of common shares and dilutive common share equivalents and convertible securities then outstanding.

The following provides a reconciliation of information used in calculating the per share amounts for the three months ended December 31 (in thousands, except per share data):

	Net Income		Weighted Average Shares		Net Income per Share	
	2013	2012	2013	2012	2013	2012
Basic EPS	\$ 368	\$ 135	19,408	19,154	\$ 0.02	\$ 0.01
Effect of Dilutive Securities:						
Stock Options	--	--	36	342	--	--
Diluted EPS	\$ 368	\$ 135	19,444	19,496	\$ 0.02	\$ 0.01

Options to purchase 131,402 and 395,750 shares of common stock for the three months ended December 31, 2013 and 2012, respectively, were not included in the computation of Diluted EPS because their inclusion would be anti-dilutive. These options were still outstanding at the end of the respective periods.

The following provides a reconciliation of information used in calculating the per share amounts for the six months ended December 31 (in thousands, except per share data):

	Net Income (Loss)		Weighted Average Shares		Net Income (Loss) per Share	
	2013	2012	2013	2012	2013	2012
Basic EPS	\$ 491	\$ (299 )	19,366	19,125	\$ 0.03	\$ (0.02 )
Effect of Dilutive Securities:						
Stock Options	--	--	27	--	--	--
Diluted EPS	\$ 491	\$ (299 )	19,393	19,125	\$ 0.03	\$ (0.02 )

Options to purchase 199,759 and 681,140 shares of common stock for the six months ended December 31, 2013 and 2012, respectively, were not included in the computation of Diluted EPS because their inclusion would be anti-dilutive. These options were still outstanding at the end of the respective periods.

#### Stock-Based Compensation

The Company has established share incentive programs as discussed in Note 7.

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the vesting period. Determining the fair value of share-based awards at the grant date requires assumptions and judgments about expected volatility and forfeiture rates, among other factors.

Stock-based compensation costs of \$6 and \$0 were recognized for the three months ended December 31, 2013 and 2012, respectively and \$7 and \$0 for the six months ended December 31, 2013 and 2012, respectively .

#### Foreign Currency

All assets and liabilities of foreign subsidiaries are translated into U.S. Dollars at fiscal period-end exchange rates. Income and expense items are translated at the prevailing exchange rates during the reporting period. The realized and unrealized gains and losses associated with foreign currency translation, as well as related other comprehensive income, were not material for the six months ended December 31, 2013 and 2012.





### Comprehensive Income

For the six months ended December 31, 2013 and 2012 the Company's operations did not give rise to material items includable in comprehensive income which were not already included in net income. Accordingly, the Company's comprehensive income approximates its net income for all periods presented.

### Segment Reporting

The Company's reportable operating segments are determined based on the Company's management approach. The management approach is based on the way that the chief operating decision maker organizes the segments within an enterprise for making operating decisions and assessing performance. The Company's results of operations are reviewed by the chief operating decision maker on a consolidated basis and the Company operates in only one segment. The Company has presented required geographical data in Note 11, and no additional segment data has been presented.

### Shipping and Handling Revenues and Costs

The Company records the amount billed to customers for shipping and handling in net sales (\$121,000 and \$128,000 in the three months ended December 31, 2013 and 2012, respectively and \$252,000 and \$249,000 in the six months ended December 31, 2013 and 2012, respectively) and classifies the costs associated with these revenues in cost of sales (\$221,000 and \$259,000 in the three months ended December 31, 2013 and 2012, respectively and \$463,000 and \$482,000 in the six months ended December 31, 2013 and 2012, respectively).

### Recently Issued Accounting Standards

In July 2013, the FASB issued authoritative guidance that requires an entity to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, in the financial statements as a reduction to a deferred tax asset for a net operating loss ("NOL") carryforward, a similar tax loss, or a tax credit carryforward. If either (i) an NOL carryforward, a similar tax loss, or tax credit carryforward is not available as of the reporting date under the governing tax law to settle taxes that would result from the disallowance of the tax position or (ii) the entity does not intend to use the deferred tax asset for this purpose (provided that the tax law permits a choice), an entity should present an unrecognized tax benefit in the financial statements as a liability and should not net the unrecognized tax benefit with a deferred tax asset. This guidance becomes effective prospectively for unrecognized tax benefits that exist as of the Company's fiscal 2015 first quarter, with retrospective application and early adoption permitted. The Company is currently evaluating the timing of adoption and the impact of this balance sheet presentation guidance but does not expect it to have a significant impact on the Company's consolidated financial statements.

### NOTE 2 - Business and Credit Concentrations

The Company had one customer with accounts receivable balance that comprised 13% of the Company's accounts receivable at December 31, 2013 and two customers that aggregated 22% at June 30, 2013. Sales to any one customer did not exceed 10% of net sales in any of the past two fiscal years.

### NOTE 3 - Inventories

Inventories, net of reserves are valued at lower of cost (first-in, first-out method) or market. The Company regularly reviews parts and finished goods inventories on hand and, when necessary, records a provision for excess or obsolete

inventories. The balance in these reserves was \$3,517,000 and \$3,392,000 as of December 31, 2013 and June 30, 2013, respectively. The Company also regularly reviews the period over which its inventories will be converted to sales. Any inventories expected to convert to sales beyond 12 months from the balance sheet date are classified as non-current.

Inventories, net of reserves consist of the following (in thousands):

	December 31, 2013	June 30, 2013
Component parts	\$ 13,775	\$ 13,112
Work-in-process	3,282	3,125
Finished product	5,957	5,670
	\$ 23,014	\$ 21,907
Classification of inventories, net of reserves:		
Current	\$ 19,788	\$ 18,471
Non-current	3,226	3,436
	\$ 23,014	\$ 21,907

## NOTE 4 - Property, Plant, and Equipment

Property, plant and equipment consist of the following (in thousands):

	December 31, 2013	June 30, 2013	Useful Life in Years
Land	\$ 904	\$ 904	--
Buildings	8,911	8,911	30 to 40
Molds and dies	6,836	6,794	3 to 5
Furniture and fixtures	2,367	2,328	5 to 10
Machinery and equipment	19,716	19,431	7 to 10
Leasehold improvements	372	372	Shorter of the lease term or life of asset
	39,106	38,740	
Less: accumulated depreciation and amortization	32,594	32,154	
	\$ 6,512	\$ 6,586	

Depreciation and amortization expense on property, plant, and equipment was \$223,000 and \$256,000 for the three months ended December 31, 2013 and 2012, respectively and \$440,000 and \$507,000 for the six months ended December 31, 2013 and 2012, respectively.

## NOTE 5 - Income Taxes

The provision for income taxes represents Federal, foreign, and state and local income taxes. The effective rate differs from statutory rates due to the effect of state and local income taxes, tax rates in foreign jurisdictions, tax benefit of R&D credits and certain nondeductible expenses. Our effective tax rate will change from quarter to quarter based on recurring and non-recurring factors including, but not limited to, the geographical mix of earnings, enacted tax legislation, and state and local income taxes. In addition, changes in judgment from the evaluation of new information resulting in the recognition, de-recognition or re-measurement of a tax position taken in a prior annual period are recognized separately in the quarter of the change.

The Company does not expect that our unrecognized tax benefits will significantly change within the next twelve months. We file a consolidated U.S. income tax return and tax returns in certain state and local and foreign jurisdictions. As of December 30, 2013 we remain subject to examination in all tax jurisdictions for all relevant jurisdictional statutes for fiscal years 2008 and thereafter.

The Company has identified its U.S. Federal income tax return and its State return in New York as its major tax jurisdictions. During the six months ended December 31, 2013 the Company increased its reserve for uncertain income tax positions by \$11,000. As a result, as of December 31, 2013 and June 30, 2013 the Company has a long-term accrued income tax liability of \$164,000 and \$153,000, respectively.

## NOTE 6 - Long-Term Debt

As of December 31, 2013, long-term debt consisted of a revolving credit facility of \$11,000,000 (the "Revolving Credit Facility") which expires in June 2017 and two term loans, one for \$6,000,000 which expires in June 2019, and one for

\$6,500,000 which expires in June 2017 (the "Term Loans"). Repayment of the Terms Loans commenced on September 30, 2012. The \$6,000,000 Term Loan is being repaid with 28 equal, quarterly payments of \$75,000 and the remaining balance of \$3,900,000 due on or before the expiration date. The \$6,500,000 Term Loan is being repaid in 20 equal, quarterly payments of \$325,000.

Outstanding balances and interest rates as of December 31, 2013 and June 30, 2013 are as follows:

	December 31, 2013			June 30, 2013		
	Outstanding	Interest Rate		Outstanding	Interest Rate	
Revolving line of credit	\$ 3,000	2.2	%	\$ 5,500	2.5	%
Term loans	10,100	2.2	%	10,900	2.5	%
Total debt	\$ 13,100	2.2	%	\$ 16,400	2.5	%

The Revolving Credit Facility and Term Loans (collectively the “Agreement”) also provide for a LIBOR-based interest rate option of LIBOR plus 2.0% to 2.75%, depending on the ratio of outstanding debt to EBITDA, which is to be measured and adjusted quarterly, a prime rate-based option of the prime rate plus 0.25% and other terms and conditions as more fully described in the Agreement. In addition, the Agreement provides for availability under the Revolving Credit Facility to be limited to the lesser of \$11,000,000 or the result of a borrowing base formula based upon the Company’s Accounts Receivables and Inventory values net of certain deductions. The Company’s obligations under the Agreement continue to be secured by all of its assets, including but not limited to, deposit accounts, accounts receivable, inventory, the Company’s corporate headquarters in Amityville, NY, equipment and fixtures and intangible assets. In addition, the Company’s wholly-owned subsidiaries, with the exception of the Company’s foreign subsidiaries, have issued guarantees and pledges of all of their assets to secure the Company’s obligations under the Agreement. All of the outstanding common stock of the Company’s domestic subsidiaries and 65% of the common stock of the Company’s foreign subsidiaries has been pledged to secure the Company’s obligations under the Agreement.

The Agreement contains various restrictions and covenants including, among others, restrictions on payment of dividends, restrictions on borrowings and compliance with certain financial ratios, as defined in the Agreement.

#### NOTE 7 - Stock Options

In December 2012, the stockholders approved the 2012 Employee Stock Option Plan (the 2012 Employee Plan). The 2012 Employee Plan authorizes the granting of awards, the exercise of which would allow up to an aggregate of 950,000 shares of the Company's common stock to be acquired by the holders of such awards. Under this plan, the Company may grant stock options, which are intended to qualify as incentive stock options (ISOs), to valued employees. Any plan participant who is granted ISOs and possesses more than 10% of the voting rights of the Company's outstanding common stock must be granted an option with a price of at least 110% of the fair market value on the date of grant.

Under the 2012 Employee Plan, stock options may be granted to valued employees with a term of up to 10 years at an exercise price equal to or greater than the fair market value on the date of grant and are exercisable, in whole or in part, at 20% per year beginning on the date of grant. An option granted under this plan shall vest in full upon a “change in control” as defined in the plan. At December 31, 2013, 78,500 stock options were granted, 15,700 stock options were exercisable and 871,500 stock options were available for grant under this plan.

The fair value of each option granted during fiscal 2014 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

Risk-free interest rates	2.7%
Expected lives	10
years	
Expected volatility	57%

Expected dividend yields 0%

The following table reflects activity under the 2012 Employee Plan for the six months ended December 31, 2013:

	Options	Weighted average exercise price
Outstanding, beginning of year	--	\$ --
Granted	78,500	5.73
Terminated	--	--
Exercised	--	--
Outstanding, end of period	78,500	\$ 5.73
Exercisable, end of period	15,700	\$ 5.73
Weighted average fair value at grant date of options granted	\$ 3.84	
Total intrinsic value of options exercised	n/a	
Total intrinsic value of options outstanding	\$ 44,120	
Total intrinsic value of options exercisable	\$ 8,824	

The following table summarizes information about stock options outstanding under the 2012 Employee Plan at December 31, 2013:

Range of exercise prices	Number outstanding	Options outstanding		Options exercisable	
		Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$ 4.00 - \$ 7.00	78,500	9.8	\$ 5.73	15,700	\$ 5.73
	78,500	9.8	\$ 5.73	15,700	\$ 5.73

As of December 31, 2013, there was \$297,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Employee Plan. The total fair value of the options vesting during the three and six months ended December 31, 2013 under this plan was \$37,000 and \$60,000, respectively.

In December 2012, the stockholders approved the 2012 Non-Employee Stock Option Plan (the 2012 Non-Employee Plan). This plan authorizes the granting of awards, the exercise of which would allow up to an aggregate of 50,000 shares of the Company's common stock to be acquired by the holders of such awards. Under this plan, the Company may grant stock options to non-employee directors and consultants to the Company and its subsidiaries.

Under the 2012 Non-Employee Plan, stock options may be granted with a term of up to 10 years at an exercise price equal to or greater than the fair market value on the date of grant and are exercisable in whole or in part at 20% per year beginning on the date of grant. An option granted under this plan shall vest in full upon a "change in control" as defined in the plan. At December 31, 2013, 25,000 stock options were granted, 5,000 stock options were exercisable and 25,000 stock options were available for grant under this plan.

The fair value of each option granted during fiscal 2014 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

Risk-free interest rates	2.7%
Expected lives	10
years	
Expected volatility	57%
Expected dividend yields	0%

The following table reflects activity under the 2012 Non-Employee Plan for the six months ended December 31, 2013:

	Options	Weighted average exercise price
Outstanding, beginning of year	--	\$ --
Granted	25,000	4.88
Terminated	--	--
Exercised	--	--
Outstanding, end of period	25,000	\$ 4.88
Exercisable, end of period	5,000	\$ 4.88



Weighted average fair value at grant date of options granted	\$	3.30
Total intrinsic value of options exercised		n/a
Total intrinsic value of options outstanding	\$	35,000
Total intrinsic value of options exercisable	\$	7,000

The following table summarizes information about stock options outstanding under the 2012 Non-Employee Plan at December 31, 2013:

Range of exercise prices	Number outstanding	Options outstanding		Options exercisable	
		Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$ 4.00 - \$ 5.00	25,000	9.7	\$ 4.88	5,000	\$ 4.88
	25,000	9.7	\$ 4.88	5,000	\$ 4.88

As of December 31, 2013, there was \$80,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Employee Plan. The total fair value of the options vesting during the three and six months ended December 31, 2013 under this plan was \$17,000 and \$0, respectively.

In December 2002, the stockholders approved the 2002 Employee Stock Option Plan (the 2002 Employee Plan). This plan expired in October 2012. This plan authorized the granting of awards, the exercise of which would allow up to an aggregate of 1,836,000 shares of the Company's common stock to be acquired by the holders of such awards. Under this plan, the Company may have granted stock options, which were intended to qualify as incentive stock options (ISOs), to key employees. Any plan participant who was granted ISOs and possessed more than 10% of the voting rights of the Company's outstanding common stock must have been granted an option with a price of at least 110% of the fair market value on the date of grant.

Under the 2002 Employee Plan, stock options have been granted to key employees with a term of 10 years at an exercise price equal to the fair market value on the date of grant and are exercisable in whole or in part at 20% per year from the date of grant. At December 31, 2013, 1,471,480 stock options were granted, 294,100 stock options were exercisable and no further stock options were available for grant under this plan. No options were granted under this plan during the six months ended December 31, 2012.

The following table reflects activity under the 2002 Employee plan for the six months ended December 31,:

	2013		2012	
	Options	Weighted average exercise price	Options	Weighted average exercise price
Outstanding, beginning of year	651,140	\$ 4.18	1,380,140	\$ 2.95
Granted	--	--	--	--
Terminated/Lapsed	(30,240 )	1.74	--	--
Exercised	(326,800 )	2.70	(27,000 )	1.76
Outstanding, end of period	294,100	\$ 6.07	1,353,140	\$ 2.95
Exercisable, end of period	294,100	\$ 6.07	1,353,140	\$ 2.95
Weighted average fair value at grant date of options granted	n/a		n/a	
Total intrinsic value of options exercised	\$ 854,000		\$ 36,000	
Total intrinsic value of options outstanding	\$ 254,000		\$ 1,459,000	

Total intrinsic value of options exercisable	\$ 254,000	\$ 1,459,000
--	------------	--------------

326,800 and 27,000 stock options were exercised during the six months ended December 31, 2013 and 2012, respectively. 324,100 of the 326,800 exercises were settled by exchanging 164,859 shares of the Company's common stock of which 85,170 was retired upon receipt. The 27,000 exercise was settled by exchanging 13,807 shares of the Company's common stock, which was retired upon receipt. Cash received from option exercises was \$5,103 and \$0 for the six months ended December 31, 2013 and 2012, respectively, and the actual tax benefit realized for the tax deductions from option exercises was \$0 for each of these periods.

The following table summarizes information about stock options outstanding under the 2002 Employee Plan at December 31, 2013:

Range of exercise prices	Options outstanding and exercisable		
	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price
\$ 1.62 - \$ 4.00	28,350	0.2	\$ 1.90
\$ 4.01 - \$ 7.50	228,250	2.3	5.75
\$ 7.51 - \$11.16	37,500	2.2	11.16
	294,100	2.1	\$ 6.07

In September 2000, the stockholders approved a 10 year extension of the already existing 1990 non-employee stock option plan (the 2000 Non-employee Plan) to encourage non-employee directors and consultants of the Company to invest in the Company's stock. This plan expired in September 2010. No further options may be granted under this plan. This plan provided for the granting of non-qualified stock options, the exercise of which would allow up to an aggregate of 270,000 shares of the Company's common stock to be acquired by the holders of the stock options. This plan provided that the option price will not be less than 100% of the fair market value of the stock at the date of grant. Outstanding options are exercisable at 20% per year and expire five years after the date of grant. Compensation cost was recognized for the fair value of the options granted to non-employee directors and consultants as of the date of grant.

The following table reflects activity under the 2000 Non-employee Plan for the six months ended December 31,

	2013		2012	
	Options	Weighted average exercise price	Options	Weighted average exercise price
Outstanding, beginning of period	30,000	\$ 5.03	30,000	\$ 5.03
Granted	--	--	--	--
Terminated/Lapsed	(30,000 )	5.03	--	--
Exercised	--	--	--	--
Outstanding, end of period	--	\$ --	30,000	\$ 5.03
Exercisable, end of period	--	\$ --	30,000	\$ 5.03
Weighted average fair value at grant date of options granted	n/a		n/a	
Total intrinsic value of options exercised	n/a		n/a	
Total intrinsic value of options outstanding	\$ 0		\$ 0	
Total intrinsic value of options exercisable	\$ 0		\$ 0	

NOTE 8 – Stockholders' Equity Transactions

During the six months ended December 31, 2013, certain employees exercised incentive stock options under the Company's 2002 Plan totaling 326,800 shares. 324,100 of these exercises were completed as cashless exercises as allowed for under the 2002 Plan, where the exercise shares are issued by the Company in exchange for shares of the Company's common stock that are owned by the optionees. The number of shares surrendered by the optionees are based upon the per share price on the effective date of the option exercise. In addition, the Company repurchased 50,000 shares of its Common Stock from its Chief Executive Officer ("CEO"). The purchase price was \$5.70 per share, the previous business day's closing price on NASDAQ, for an aggregate purchase price of \$285,000. The repurchase was to fund the CEO's tax liability associated with the exercise of 135,000 options granted to him under the 2002 Plan. The repurchase was approved by the Board of Directors of the Company, including all of the independent directors.

#### NOTE 9 - 401(k) Plan

The Company maintains a 401(k) plan ("the Plan") that covers all U.S. non-union employees with one or more years of service and is qualified under Sections 401(a) and 401(k) of the Internal Revenue Code. Company contributions to this plan are discretionary and totaled \$25,000 and \$23,000 for the three months ended December 31, 2013 and 2012, respectively and \$51,000 and \$44,000 for the six months ended December 31, 2013 and 2012, respectively.

#### NOTE 10 - Commitments and Contingencies

##### Leases

The Company is committed under various operating leases, not including the land lease discussed below, which do not extend beyond fiscal 2016.

Rent expense, with the exception of the land lease referred to below, totaled approximately \$9,000 and \$12,000 for the three months ended December 31, 2013 and 2012, respectively and \$18,000 and \$23,000 for the six months ended December 31, 2013 and 2012, respectively.

##### Land Lease

On April 26, 1993, one of the Company's foreign subsidiaries entered into a 99 year lease, expiring in 2092, for approximately four acres of land in the Dominican Republic at an annual cost of \$288,000, on which the Company's principal production facility is located.

##### Litigation

In the normal course of business, the Company is a party to claims and/or litigation. Management believes that the settlement of such claims and/or litigation, considered in the aggregate, will not have a material adverse effect on the Company's financial position and results of operations.

##### Employment Agreements

As of June 30, 2013, the Company was obligated under two employment agreements and one severance agreement. The employment agreements are with the Company's CEO and Senior Vice President of Sales and Marketing ("the SVP"). The employment agreement with the CEO provides for an annual salary of \$587,000, as adjusted for inflation; incentive compensation as may be approved by the Board of Directors from time to time and a termination payment in an amount up to 299% of the average of the prior five calendar year's compensation, subject to certain limitations, as defined in the agreement. The employment agreement renews annually in August unless either party gives the other notice of non-renewal at least six months prior to the end of the applicable term. The employment agreement with the SVP expires in October 2014 and provides for an annual salary of \$274,400 and, if terminated by the Company without cause, severance of nine months' salary and continued company-sponsored health insurance for six months from the date of termination. The severance agreement provides for payments equal to nine months of salary and six months of health insurance in the event of a non-voluntary termination of employment without cause.

#### NOTE 11 - Geographical Data

The Company is engaged in one major line of business: the development, manufacture, and distribution of security alarm products and door security devices for commercial and residential use. Sales to unaffiliated customers are primarily shipped from the United States. The Company has customers worldwide with major concentrations in North America and Europe.

The following represents selected consolidated geographical data:

Financial Information Relating to Domestic and Foreign Operations

	Three months ended December		Six months ended December 31,	
	2013	31, 2012	2013	2012
	(in thousands)		(in thousands)	
Sales to external customers (1):				
Domestic	\$ 17,593	\$ 16,105	\$ 33,887	\$ 30,370
Foreign	760	1,107	1,705	2,058
Total Net Sales	\$ 18,353	\$ 17,212	\$ 35,592	\$ 32,428
	December	June 30,		
	31,	2013		
Identifiable assets:	2013	2013		
United States	\$ 47,686	\$ 51,141		
Dominican Republic (2)	12,636	12,763		
Total Identifiable Assets	\$ 60,322	\$ 63,903		

(1) All of the Company's sales originate in the United States and are shipped primarily from the Company's facilities in the United States. There were no sales into any one foreign country in excess of 10% of total Net Sales.

(2) Consists primarily of inventories (December 31, 2013 = \$8,982; June 30, 2013 = \$9,105) and fixed assets (December 31, 2013 = \$3,550; June 30, 2013 = \$3,546) located at the Company's principal manufacturing facility in the Dominican Republic.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Management's Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q and the information incorporated by reference may include "Forward-Looking Statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act of 1934. The Company intends the Forward-Looking Statements to be covered by the Safe Harbor Provisions for Forward-Looking Statements. All statements regarding the Company's expected financial position and operating results, its business strategy, its financing plans and the outcome of any contingencies are Forward-Looking Statements. The Forward-Looking Statements are based on current estimates and projections about our industry and our business. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," or variations of such words and similar expressions are intended to identify such Forward-Looking Statements. The Forward-Looking Statements are subject to risks and uncertainties that could cause actual results to differ materially from those set forth or implied by any Forward-Looking Statements. For example, the Company is highly dependent on its Chief Executive Officer for strategic planning. If he is unable to perform his services for any significant period of time, the Company's ability to grow could be adversely affected. In addition, factors that could cause actual results to differ materially from the Forward-Looking Statements include, but are not limited to, the uncertain economic, military and political conditions in the world, the ability to maintain adequate financing, our ability to maintain and develop competitive products, adverse tax consequences of offshore operations, significant fluctuations in the exchange rate between the Dominican Peso and the U.S. Dollar, distribution problems, and unforeseen environmental liabilities.



## Overview

The Company is a diversified manufacturer of security products, encompassing electronic locking devices, intrusion and fire alarms and building access control systems. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment. International sales accounted for approximately 5% and 6% of our revenues for both of the six month periods ended December 31, 2013 and 2012, respectively.

The Company owns and operates manufacturing facilities in Amityville, New York and the Dominican Republic. A significant portion of our operating costs are fixed, and do not fluctuate with changes in production levels or utilization of our manufacturing capacity. As production levels rise and factory utilization increases, the fixed costs are spread over increased output, which should improve profit margins. Conversely, when production levels decline our fixed costs are spread over reduced levels, thereby decreasing margins.

The security products market is characterized by constant incremental innovation in product design and manufacturing technologies. Generally, the Company devotes 6-8% of revenues to research and development (R&D) on an annual basis. The Company does not expect products resulting from our R&D investments in fiscal 2014 to contribute materially to revenue during this fiscal year, but should benefit the Company over future years. In general, the new products introduced by the Company are initially shipped in limited quantities, and increase over time. Prices and manufacturing costs tend to decline over time as products and technologies mature.

#### Economic and Other Factors

We are subject to the effects of general economic and market conditions. In the event that the U.S. or international economic conditions deteriorate, our revenue, profit and cash-flow levels could be materially adversely affected in future periods. In the event of such deterioration, many of our current or potential future customers may experience serious cash flow problems and as a result may, modify, delay or cancel purchases of our products. Additionally, customers may not be able to pay, or may delay payment of, accounts receivable that are owed to us. If such events do occur, they may result in our expenses being too high in relation to our revenues and cash flows.

#### Seasonality

The Company's fiscal year begins on July 1 and ends on June 30. Historically, the end users of Napco's products want to install its products prior to the summer; therefore sales of its products historically peak in the period April 1 through June 30, the Company's fiscal fourth quarter, and are reduced in the period July 1 through September 30, the Company's fiscal first quarter. In addition, demand is affected by the housing and construction markets. Deterioration of the current economic conditions may also affect this trend.

#### Critical Accounting Policies and Estimates

The Company's significant accounting policies are fully described in Note 1 to the Company's consolidated financial statements included in its 2013 Annual Report on Form 10-K. Management believes the following critical accounting policies, among others, affect its more significant judgments and estimates used in the preparation of its consolidated financial statements.

#### Revenue Recognition

The Company recognizes revenue when the following criteria are met: (i) persuasive evidence of an agreement exists, (ii) there is a fixed and determinable price for the Company's product, (iii) shipment and passage of title occurs and (iv) collectability is reasonably assured. Revenues from product sales are recorded at the time the product is shipped or delivered to the customer pursuant to the terms of the sale. The Company reports its sales on a net sales basis, with net sales being computed by deducting from gross sales the amount of actual sales returns and other allowances and the amount of reserves established for anticipated sales returns and other allowances.

The Company analyzes sales returns and is able to make reasonable and reliable estimates of product returns based on the Company's past history. Estimates for sales returns are based on several factors including actual returns and based on expected return data communicated to it by its customers. Accordingly, the Company believes that its historical returns analysis is an accurate basis for its allowance for sales returns. Actual results could differ from those estimates.

#### Concentration of Credit Risk

An entity is more vulnerable to concentrations of credit risk if it is exposed to risk of loss greater than it would have had if it mitigated its risk through diversification of customers. Such risks of loss manifest themselves differently,

depending on the nature of the concentration, and vary in significance. The Company had one customer with accounts receivable balance that comprised 13% of the Company's accounts receivable at December 31, 2013 and two customers that aggregated 22% at June 30, 2013. Sales to any one customer did not exceed 10% of net sales in any of the past two fiscal years.

In the ordinary course of business, we have established a reserve for doubtful accounts and customer deductions in the amount of \$230,000 and \$220,000 as of December 31, 2013 and June 30, 2013, respectively. Our reserve for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This reserve is based upon the evaluation of accounts receivable agings, specific exposures and historical or anticipated events.

#### Inventories

Inventories are valued at the lower of cost or fair market value, with cost being determined on the first-in, first-out (FIFO) method. The reported net value of inventory includes finished saleable products, work-in-process and raw materials that will be sold or used in future periods. Inventory costs include raw materials, direct labor and overhead. The Company's overhead expenses are applied based, in part, upon estimates of the proportion of those expenses that are related to procuring and storing raw materials as compared to the manufacture and assembly of finished products. These proportions, the method of their application, and the resulting overhead included in ending inventory, are based in part on subjective estimates and actual results could differ from those estimates.

In addition, the Company records an inventory obsolescence reserve, which represents the difference between the cost of the inventory and its estimated market value, based on various product sales projections. This reserve is calculated using an estimated obsolescence percentage applied to the inventory based on age, historical trends, requirements to support forecasted sales, and the ability to find alternate applications of its raw materials and to convert finished product into alternate versions of the same product to better match customer demand. There is inherent professional judgment and subjectivity made by both production and engineering members of management in determining the estimated obsolescence percentage. In addition, and as necessary, the Company may establish specific reserves for future known or anticipated events. The Company also regularly reviews the period over which its inventories will be converted to sales. Any inventories expected to convert to sales beyond 12 months from the balance sheet date are classified as non-current.

### Intangible Assets

The Company evaluates its Intangible Assets for impairment at least on an annual basis. Those intangible assets that are classified as goodwill or as other intangibles with indefinite lives are not amortized. Impairment testing is performed in two steps: (i) the Company determines impairment by comparing the fair value of a reporting unit with its carrying value, and (ii) if there is impairment, the Company measures the amount of impairment loss by comparing the implied fair value of intangible assets with the carrying amount of the intangible assets.

### Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income tax expense represents the change during the period in the deferred tax assets and deferred tax liabilities. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company measures and recognizes the tax implications of positions taken or expected to be taken in its tax returns on an ongoing basis.

### Results of Operations

	Three months ended December 31, (dollars in thousands)			Six months ended December 31, 2013 (dollars in thousands)			
	2013	2012	% Increase/ (decrease)	2013	2012	% Increase/ (decrease)	
Net sales	\$18,353	\$17,212	6.6 %	\$35,592	\$32,428	9.8 %	
Gross profit	5,081	4,641	9.5 %	10,120	8,777	15.3 %	
Gross profit as a % of net sales	27.7 %	27.0 %	2.6 %	28.4 %	27.1 %	4.8 %	
Selling, general and administrative	4,547	4,287	6.1 %	9,324	8,822	5.7 %	
Selling, general and administrative as a percentage of net sales	24.8 %	24.9 %	(0.4) %	26.2 %	27.2 %	(3.7) %	

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Operating income (loss)	534	354	50.8	%	796	(45	)	1,868.9	%
Interest expense, net	110	141	(22.0	)%	231	318		(27.4	)%
Other expense	4	4	--	%	7	7		--	%
Provision (benefit) for income taxes	52	74	(29.7	)%	67	(71	)	194.4	%
Net income (loss)	368	135	172.6	%	491	(299	)	264.2	%

Sales for the three months ended December 31, 2013 increased 7% to \$18,353,000 as compared to \$17,212,000 for the same period a year ago. Sales for the six months ended December 31, 2013 increased 10% to \$35,592,000 as compared to \$32,428,000 for the same period a year ago. The increase in sales for the three months ended December 31, 2013 was due primarily to increased sales in the Company's door-locking products (\$1,241,000) and access control (\$187,000) products as partially offset by a decrease in intrusion products (\$286,000). The increase in sales for the six months ended December 31, 2013 was due primarily to increased sales in the Company's door-locking products (\$2,524,000) and access control (\$906,000) products as partially offset by a decrease in intrusion products (\$266,000). The increase in sales of door-locking products for the three and six months was due primarily to general increased demand for the Company's door-locking products. The increase in sales of access control products for the six months was due primarily to a large order of \$1,734,000 received from a major university in the quarter ended June 30, 2013. The Company shipped \$1,127,000 of this order in the quarter ended June 30, 2013 and completed delivery of the remaining \$607,000 during the first three months of fiscal 2014. Intrusion sales were impacted by a temporary delay in processing orders from a large distributor.

Gross profit for the three months ended December 31, 2013 increased to \$5,081,000 or 27.7% of sales as compared to \$4,641,000 or 27.0% of sales for the same period a year ago. Gross profit for the six months ended December 31, 2013 increased to \$10,120,000 or 28.4% of sales as compared to \$8,777,000 or 27.1% of sales for the same period a year ago. The increase in gross profit for the three and six months was primarily due to the aforementioned increase in net sales, a positive shift in product mix to the Company's door-locking products and a reduction in research and development costs as a result of the completion of development of the Company's iBridge product line.

Selling, general and administrative expenses for the three months ended December 31, 2013 increased by \$260,000 to \$4,547,000 from \$4,287,000 for the same period a year ago. Selling, general and administrative expenses for the six months ended December 31, 2013 increased by \$502,000 to \$9,324,000 from \$8,822,000 for the same period a year ago. Selling, general and administrative expenses as a percentage of net sales decreased to 24.8% for the three months ended December 31, 2013 from 24.9% for the same period a year ago. Selling, general and administrative expenses as a percentage of net sales decreased to 26.2% for the six months ended December 31, 2013 from 27.2% for the same period a year ago. The increase in dollars for the three and six months was due primarily from the addition of selling personnel.

Interest expense, net for the three months ended December 31, 2013 decreased by \$31,000 to \$110,000 as compared to \$141,000 for the same period a year ago. Interest expense, net for the six months ended December 31, 2013 decreased by \$87,000 to \$231,000 as compared to \$318,000 for the same period a year ago. The decreases in interest expense for the three and six months ended December 31, 2013 resulted from lower average outstanding debt during those periods as compared to the same periods a year ago.

The Company's provision for income taxes for the three months ended December 31, 2013 decreased by \$22,000 to \$52,000 as compared to \$74,000 for the same period a year ago. The Company's provision for income taxes for the six months ended December 31, 2013 increased by \$138,000 to a provision of \$67,000 as compared to a benefit of \$71,000 for the same period a year ago. The changes in the provision for income taxes were caused primarily by the increase in income before income taxes as well as a change in the proportion of the income before income taxes being generated by the Company's U.S. operations to the loss being generated by non-taxable foreign operations for the three and six months ended December 31, 2013 as compared to the same periods a year ago. As a result, the Company's effective rate for income tax was 12% and 35% for the three months ended December 31, 2013 and 2012, respectively and 12% and 19% for the six months ended December 31, 2013 and 2012, respectively.

Net income increased by \$233,000 to \$368,000 or \$0.02 per diluted share for the three months ended December 31, 2013 as compared to \$135,000 or \$0.01 per diluted share for the same period a year ago. Net income increased by \$790,000 to \$491,000 or \$0.03 per diluted share for the six months ended December 31, 2013 as compared to a loss of \$(299,000) or \$(0.02) per diluted share for the same period a year ago. The changes for the three and six months ended December 31, 2013 were primarily due to the items as described above.

#### Liquidity and Capital Resources

During the six months ended December 31, 2013 the Company utilized a portion of its cash from operations (\$3,951,000 of \$4,096,000) to repay outstanding debt (\$3,300,000), purchase treasury stock (\$285,000) and purchase property, plant and equipment (\$366,000). The Company believes its current working capital, cash flows from operations and its revolving credit agreement will be sufficient to fund the Company's operations through the next twelve months.

Accounts Receivable at December 31, 2013 decreased \$4,507,000 to \$13,704,000 as compared to \$18,211,000 at June 30, 2013. This decrease is primarily the result of the lower sales volume during the quarter ended December 31, 2013 as compared to the quarter ended June 30, 2013, which is typically the Company's highest.

Inventories at December 31, 2013 increased \$1,107,000 to \$23,014,000 as compared to \$21,907,000 at June 30, 2013. This increase is primarily the result of the Company keeping additional inventory of recently introduced products, level-loading its production facility in the Dominican Republic as well as the higher sales levels in the quarter ended June 30, 2013 as compared to the quarter ended December 31, 2013.

Accounts payable and accrued expenses decreased \$531,000 to \$6,484,000 as of December 31, 2013 as compared to \$7,015,000 at June 30, 2013. This decrease is due primarily to lower production levels during the quarter ended December 31, 2013 as compared to the quarter ended June 30, 2013.

As of December 31, 2013, long-term debt consisted of a revolving credit facility of \$11,000,000 (the "Revolving Credit Facility") which expires in June 2017 and two term loans, one for \$6,000,000 which expires in June 2019, and one for \$6,500,000 which expires in June 2017 (the "Term Loans"). Repayment of the Terms Loans commenced on September 30, 2012. The \$6,000,000 Term Loan is being repaid with 28 equal, quarterly payments of \$75,000 and the remaining balance of \$3,900,000 due on or before the expiration date. The \$6,500,000 Term Loan is being repaid in 20 equal, quarterly payments of \$325,000. As of December 31, 2013, the Company had \$3,000,000 in outstanding borrowings and \$8,000,000 in availability under the Revolving Credit Facility. The Company's long-term debt is described more fully in Note 6 to the condensed consolidated financial statements.

The agreements contain various restrictions and covenants including, among others, restrictions on payment of dividends, restrictions on borrowings and compliance with certain financial ratios, as defined in the restated agreement.

As of December 31, 2013 the Company had no material commitments for capital expenditures or inventory purchases other than purchase orders issued in the normal course of business.

### ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

The Company's principal financial instrument is long-term debt (consisting of a revolving credit facility and term loans) that provides for interest based on the prime rate or LIBOR as described in the agreement. The Company is affected by market risk exposure primarily through the effect of changes in interest rates on amounts payable by the Company under these credit facilities. At December 31, 2013, an aggregate principal amount of approximately \$13,100,000 was outstanding under the Company's credit facilities with a weighted average interest rate of approximately 2.2%. If principal amounts outstanding under the Company's credit facilities remained at this level for an entire year and the interest rate increased or decreased, respectively, by 1% the Company would pay or save, respectively, an additional \$131,000 in interest that year.

All foreign sales transactions by the Company are denominated in U.S. dollars. As such, the Company has shifted foreign currency exposure onto its foreign customers. As a result, if exchange rates move against foreign customers, the Company could experience difficulty collecting unsecured accounts receivable, the cancellation of existing orders or the loss of future orders. The foregoing could materially adversely affect the Company's business, financial condition and results of operations. We are also exposed to foreign currency risk relative to expenses incurred in Dominican Pesos ("RD\$"), the local currency of the Company's production facility in the Dominican Republic. The result of a 10% strengthening in the U.S. dollar to our RD\$ expenses would result in an annual decrease in income from operations of approximately \$600,000.

### ITEM 4: Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management's control objectives.

At the conclusion of the period ended December 31, 2013, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the



effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at December 31, 2013.

During the three months ended December 31, 2013, there were no changes in the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART II: OTHER INFORMATION

Item 1A. Risk Factors

Information regarding the Company's Risk Factors are set forth in the Company's Annual Report on Form 10-K for the year ended June 30, 2013. There has been no material change in the risk factors previously disclosed in the Company's Form 10-K for the year ended June 30, 2013 during the six months ended December 31, 2013.

Item 6. Exhibits

- 31.1 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Richard L. Soloway, Chairman of the Board and President
- 31.2 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Kevin S. Buchel, Senior Vice President of Operations and Finance
- 32.1 Section 1350 Certifications
- 101.INS XBRL Instance Document\*
- 101.SCH XBRL Taxonomy Extension Schema Document\*
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document\*
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document\*
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document\*
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document\*

\* Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for the purposes of section 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

SIGNATURES

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

February 10, 2014

NAPCO SECURITY TECHNOLOGIES, INC.  
(Registrant)

By: /s/ RICHARD L. SOLOWAY  
Richard L. Soloway  
Chairman of the Board of Directors, President and  
Secretary  
(Chief Executive Officer)

By: /s/ KEVIN S. BUCHEL  
Kevin S. Buchel  
Senior Vice President of Operations and Finance  
and Treasurer  
(Principal Financial and Accounting Officer)

EXHIBITS

Exhibit No.	Title
Ex-31.1	Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Richard L. Soloway, Chairman of the Board and President
Ex-31.2	Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Kevin S. Buchel, Senior Vice President of Operations and Finance
Ex-32.1	Section 1350 Certifications
Ex-101.INS	XBRL Instance Document*
Ex-101.SCH	XBRL Taxonomy Extension Schema Document*
Ex-101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document*
Ex-101.LAB	XBRL Taxonomy Extension Label Linkbase Document*
Ex-101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document*
Ex-101.DEF	XBRL Taxonomy Extension Definition Linkbase Document*

\* Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for the purposes of section 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.