

NAPCO SECURITY TECHNOLOGIES, INC  
Form 10-Q  
February 09, 2015

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE  
ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED: **DECEMBER 31, 2014**  
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 11-2277818  
(State or other jurisdiction of (IRS Employer Identification  
incorporation of organization) Number)

333 Bayview Avenue  
Amityville, New York 11701  
(Address of principal executive offices) (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)

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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  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 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:

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller reporting company

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 6, 2015

COMMON STOCK, \$.01 PAR VALUE PER SHARE 19,075,236

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

	Page
<b><u>PART I: FINANCIAL INFORMATION</u></b>	
ITEM 1. <u>Financial Statements (unaudited, except where noted)</u>	
NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES INDEX – DECEMBER 31, 2014	
<u>Condensed Consolidated Balance Sheets December 31, 2014 and June 30, 2014 (audited)</u>	3
<u>Condensed Consolidated Statements of Income for the Three Months ended December 31, 2014 and 2013</u>	4
<u>Condensed Consolidated Statements of Income for the Six Months ended December 31, 2014 and 2013</u>	5
<u>Condensed Consolidated Statements of Cash Flows for the Six Months ended December 31, 2014 and 2013</u>	
<u>Notes to Condensed Consolidated Financial Statements</u>	7
ITEM 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	18
ITEM 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	22
ITEM 4. <u>Controls and Procedures</u>	22
<b><u>PART II: OTHER INFORMATION</u></b>	
ITEM 1A. <u>Risk Factors</u>	23
ITEM 2 <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	23
ITEM 6. <u>Exhibits</u>	23
<b><u>SIGNATURE PAGE</u></b>	24

**PART I: FINANCIAL INFORMATION**

## Item 1. Financial Statements

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

	December 31, 2014 (unaudited) (in thousands, except for share data)	June 30, 2014 (audited)
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 1,710	\$ 2,483
Accounts receivable, net of reserves and allowances	15,352	16,904
Inventories	22,238	21,443
Prepaid expenses and other current assets	1,053	989
Income tax receivable	45	121
Deferred income taxes	781	739
Total Current Assets	41,179	42,679
Inventories - non-current	3,855	3,567
Deferred income taxes	965	1,005
Property, plant and equipment, net	6,306	6,394
Intangible assets, net	9,219	9,552
Other assets	156	167
<b>TOTAL ASSETS</b>	<b>\$ 61,680</b>	<b>\$ 63,364</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Current maturities of long term debt	\$ 1,600	\$ 1,600
Accounts payable	3,604	4,082
Accrued expenses	1,570	1,737
Accrued salaries and wages	1,743	1,824
Total Current Liabilities	8,517	9,243
Long-term debt, net of current maturities	9,400	10,200
Accrued income taxes	190	169
Total Liabilities	18,107	19,612
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Common Stock, par value \$0.01 per share; 40,000,000 shares authorized; 21,049,243 and 21,049,243 shares issued; and 19,114,520 and 19,419,076 shares outstanding, respectively	210	210
Additional paid-in capital	16,133	16,032
Retained earnings	36,664	35,554
	53,007	51,796

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Less: Treasury Stock, at cost (1,934,353 and 1,630,167 shares, respectively)	(9,434	)	(8,044	)
TOTAL STOCKHOLDERS' EQUITY	43,573		43,752	
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 61,680		\$ 63,364	

See accompanying notes to condensed consolidated financial statements.

3

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

	Three months ended December 31,	
	2014	2013
	(In thousands, except share and per share data)	
Net sales	\$ 19,571	\$ 18,353
Cost of sales	13,468	13,272
Gross Profit	6,103	5,081
Selling, general, and administrative expenses	5,007	4,577
Operating Income	1,096	504
Other expense:		
Interest expense, net	54	80
Other, net	3	4
Income before Income Taxes	1,039	420
Income tax expense	88	52
Net Income	\$ 951	\$ 368
Net Income per share:		
Basic	\$ 0.05	\$ 0.02
Diluted	\$ 0.05	\$ 0.02
Weighted average number of shares outstanding:		
Basic	19,188,000	19,408,000
Diluted	19,189,000	19,444,000

See accompanying notes to condensed consolidated financial statements.

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

	Six months ended December 31,	
	2014	2013
	(In thousands, except share and per share data)	
Net sales	\$ 36,907	\$ 35,592
Cost of sales	25,549	25,472
Gross Profit	11,358	10,120
Selling, general, and administrative expenses	10,016	9,376
Operating Income	1,342	744
Other expense (income):		
Interest expense, net	109	179
Other, net	(2	) 7
Income before Income Taxes	1,235	558
Income tax expense	125	67
Net Income	\$ 1,110	\$ 491
Net Income per share:		
Basic	\$ 0.06	\$ 0.03
Diluted	\$ 0.06	\$ 0.03
Weighted average number of shares outstanding:		
Basic	19,304,000	19,366,000
Diluted	19,304,000	19,393,000

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,	
	2014	2013
	(in thousands)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$ 1,110	\$ 491
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	750	837
Provision for doubtful accounts	(20 )	10
Change in inventory obsolescence reserve	—	125
Deferred income taxes	(2 )	(54 )
Stock based compensation expense	101	7
Changes in operating assets and liabilities:		
Accounts receivable	1,572	4,497
Inventories	(1,083 )	(1,232 )
Prepaid expenses and other current assets	(64 )	(150 )
Income tax receivable	76	64
Other assets	5	—
Accounts payable, accrued expenses and accrued income taxes	(705 )	(499 )
Net Cash Provided by Operating Activities	1,740	4,096
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property, plant, and equipment	(323 )	(366 )
Net Cash Used in Investing Activities	(323 )	(366 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Principal payments on long-term debt	(800 )	(3,300 )
Cash paid for purchase of treasury stock	(1,390 )	(285 )
Proceeds from exercise of stock options	—	5
Net Cash Used in Financing Activities	(2,190 )	(3,580 )
Net Increase in Cash and Cash Equivalents	(773 )	150
CASH AND CASH EQUIVALENTS - Beginning	2,483	3,229
CASH AND CASH EQUIVALENTS - Ending	\$ 1,710	\$ 3,379
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>		
Interest paid, net	\$ 110	\$ 240
Income taxes paid	\$ 30	24
<b>NON-CASH FINANCING ACTIVITIES:</b>		
Shares surrendered and held in treasury for common stock options exercised	\$ —	\$ 28
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, 2014

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 access control systems, door security products, intrusion and fire alarm systems and video surveillance products for commercial and residential use. 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 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, 2014 and the notes thereto included in the Company's Annual Report on Form 10-K filed with the SEC on September 15, 2014. 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. Certain prior period amounts relating to credit card fees have been reclassified for consistency with the current period presentation. The reclassification did not have an impact on the Balance Sheets, Statement of Cash Flows or reported Net income (loss) for any period.

#### 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 reserves for sales returns and allowances, concentration of credit risk, inventory reserves, 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, 2014 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, 2014 in the amount of \$11,000,000 approximates fair value.

#### Cash and Cash Equivalents

Cash and cash equivalents include approximately \$460,000 of short-term time deposits at December 31, 2014 and June 30, 2014. 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, 2014 and June 30, 2014. 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 \$160,000 and \$180,000 and for returns and other allowances of \$1,040,000 and \$1,005,000 as of December 31, 2014 and June 30, 2014, 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") 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 trade name was deemed to have an indefinite life.

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

	December 31, 2014			June 30, 2014		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Customer relationships	\$9,800	\$ (6,511 )	\$ 3,289	\$9,800	\$ (6,203 )	\$ 3,597
Non-compete agreement	340	(310 )	30	340	(285 )	55
Trade name	5,900	—	5,900	5,900	—	5,900
	\$16,040	\$ (6,821 )	\$ 9,219	\$16,040	\$ (6,488 )	\$ 9,552

Amortization expense for intangible assets subject to amortization was approximately \$167,000 and \$195,000 for the three months ended December 31, 2014 and 2013, respectively. Amortization expense for intangible assets subject to amortization was approximately \$333,000 and \$391,000 for the six months ended December 31, 2014 and 2013, respectively. Amortization expense for each of the next five fiscal years is estimated to be as follows: 2015 - \$667,000; 2016 - \$529,000; 2017 - \$441,000; 2018 - \$371,000 and 2019 - \$313,000. The weighted average amortization period for intangible assets was 13.5 years and 14.4 years at December 31, 2014 and 2013, 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. As a percentage of gross sales, sales returns, rebates and allowances were 7% and 6% for the three months ended December 31, 2014 and 2013, respectively. As a percentage of gross sales, sales returns, rebates and allowances were 8% and 7% for the six months ended December 31, 2014 and 2013, respectively.

#### 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, 2014 and 2013 was \$312,000 and \$247,000, respectively. Advertising expense for the six months ended December 31, 2014 and 2013 was \$856,000 and \$612,000, respectively. The increase in Advertising and promotional costs was due primarily to increased expenditures on media advertising as compared to the same period a year ago.

#### Research and Development Costs

Research and development costs incurred by the Company are charged to expense as 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, 2014 and 2013 was \$1,335,000 and \$1,252,000, respectively.

Company-sponsored research and development expense for the six months ended December 31, 2014 and 2013 was \$2,653,000 and \$2,538,000, 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 Per Share

Basic net income per common share (Basic EPS) is computed by dividing net income by the weighted average number of common shares outstanding. Diluted net income 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	
	2014	2013	2014	2013	2014	2013
Basic EPS	\$951	\$368	19,188	19,408	\$ 0.05	\$ 0.02
Effect of Dilutive Securities:						
Stock Options	—	—	1	36	—	—
Diluted EPS	\$951	\$368	19,189	19,444	\$ 0.05	\$ 0.02

Options to purchase 368,250 and 131,402 shares of common stock for the three months ended December 31, 2014 and 2013, 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		Weighted Average Shares		Net Income per Share	
	2014	2013	2014	2013	2014	2013
Basic EPS	\$1,110	\$491	19,304	19,366	\$ 0.06	\$ 0.03
Effect of Dilutive Securities:						
Stock Options	—	—	—	27	—	—
Diluted EPS	\$1,110	\$491	19,304	19,393	\$ 0.06	\$ 0.03

Options to purchase 256,875 and 199,759 shares of common stock for the six months ended December 31, 2014 and 2013, 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 two 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 \$68,000 and \$6,000 were recognized for three months ended December 31, 2014 and 2013, respectively. Stock-based compensation costs of \$101,000 and \$7,000 were recognized for six months ended December 31, 2014 and 2013, respectively. The effect on both Basic and Diluted Earnings per share was \$0.00 for the three and six months ended December 31, 2014 and 2013.

## 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 average exchange rates prevailing during the fiscal year. The realized and unrealized gains and losses associated with foreign currency translation, as well as related other comprehensive income, were not material for the three or six months ended December 31, 2014 and 2013.



## Comprehensive Income

For the three and six months ended December 31, 2014 and 2013, 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 (\$130,000 and \$121,000 in the three months ended December 31, 2014 and 2013, respectively, and \$257,000 and \$252,000 in the six months ended December 31, 2014 and 2013, respectively) and classifies the costs associated with these revenues in cost of sales (\$240,000 and \$221,000 in the three months ended December 31, 2014 and 2013, respectively, and \$481,000 and \$463,000 in the six months ended December 31, 2014 and 2013, respectively).

## Recently Issued Accounting Standards

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)," which is the new comprehensive revenue recognition standard that will supersede all existing revenue recognition guidance under U.S. GAAP. The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to a customer in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for annual and interim periods beginning on or after December 15, 2016, and early adoption is not permitted. Entities will have the option of using either a full retrospective approach or a modified approach to adopt the guidance. The Company is currently evaluating the impact of adopting this guidance.

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”) carry-forward, a similar tax loss, or a tax credit carry-forward. If either (i) an NOL carry-forward, a similar tax loss, or tax credit carry-forward 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 became effective for unrecognized tax benefits that exist as of the Company’s fiscal 2015 first quarter. The guidance did not have an impact on the Company’s consolidated financial statements.

NOTE 2 - Business and Credit Concentrations

The Company had two customers with accounts receivable balance that aggregated 23% of the Company’s accounts receivable at December 31, 2014. The Company had one customer with an accounts receivable balance that comprised 12% of the Company’s accounts receivable at June 30, 2014. 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 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, 2014	June 30, 2014
Component parts	\$ 15,929	\$ 15,268
Work-in-process	3,789	3,632
Finished product	6,375	6,110
	\$ 26,093	\$ 25,010

Classification of inventories, net of reserves:

Current	\$ 22,238	\$ 21,443
Non-current	3,855	3,567
	\$ 26,093	\$ 25,010

#### NOTE 4 – Property, Plant and Equipment

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

	December 31, 2014	June 30, 2014	Useful Life in Years
Land	\$ 904	\$ 904	—
Buildings	8,911	8,911	30 to 40
Molds and dies	6,957	6,906	3 to 5
Furniture and fixtures	2,451	2,427	5 to 10
Machinery and equipment	20,100	19,974	7 to 10
Leasehold improvements	288	288	Shorter of the lease term or life of asset
	39,611	39,410	
Less: accumulated depreciation and amortization	33,305	33,016	
	\$ 6,306	\$ 6,394	

Depreciation and amortization expense on property, plant, and equipment was \$210,000 and \$223,000 for the three months ended December 31, 2014 and 2013, respectively and \$412,000 and \$440,000 for the six months ended December 31, 2014 and 2013, 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 is 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 31, 2014 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. As of December 31, 2014 and June 30, 2014 the Company has a long-term accrued income tax liability of \$190,000 and \$169,000, respectively.

NOTE 6 - Long-Term Debt

As of December 31, 2014, 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 Term 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, 2014 and June 30, 2014 are as follows:

	December 31, 2014		June 30, 2014		
	Outstanding	Interest Rate	Outstanding	Interest Rate	
Revolving line of credit	\$ 2,500	1.7	% \$2,500	1.7	%
Term loans	8,500	1.7	% 9,300	1.7	%
Total debt	\$ 11,000	1.7	% \$11,800	1.7	%

The Revolving Credit Facility and Term Loans (collectively the “Agreement”) also provides for a LIBOR-based interest rate option of LIBOR plus 1.5% 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

The Company follows ASC 718 (“Share-Based Payment”), which requires that all share based payments to employees, including stock options, be recognized as compensation expense in the consolidated financial statements based on their fair values and over the requisite service period. For the three months ended December 31, 2014 and 2013, the Company recorded non-cash compensation expense of \$67,000 (\$.00 per basic and diluted share) and \$6,000 (\$.00 per basic and diluted share), respectively, relating to stock-based compensation. For the six months ended December 31, 2014 and 2013, the Company recorded non-cash compensation expense of \$101,000 (\$.01 per basic and diluted share) and \$7,000 (\$.00 per basic and diluted share), respectively, relating to stock-based compensation.

#### 2012 Employee Stock Option Plan

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, 2014, 112,500 stock options were granted, 27,500 stock options were exercisable and 837,500 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	2.3%
Expected lives	10 years
Expected volatility	54%
Expected dividend yields	0%

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

	2014		2013	
	Options	Weighted average exercise price	Options	Weighted average exercise price
Outstanding, beginning of year	78,500	\$ 5.73	—	\$ —
Granted	44,000	4.43	78,500	5.73
Terminated/Lapsed	(10,000 )	4.88	—	—
Exercised	—	—	—	—
Outstanding, end of period	112,500	\$ 5.30	78,500	\$ 5.73
Exercisable, end of period	27,500	\$ 5.26	15,700	\$ 5.73
Weighted average fair value at grant date of options granted	\$2.82		\$3.84	
Total intrinsic value of options exercised	n/a		n/a	
Total intrinsic value of options outstanding	\$13,000		\$44,000	
Total intrinsic value of options exercisable	\$3,000		\$9,000	

The following table summarizes information about stock options outstanding under the 2012 Employee Plan at December 31, 2014:

Range of exercise prices	Options outstanding		Weighted average exercise price	Options exercisable	
	Number outstanding	Weighted average remaining contractual life		Number exercisable	Weighted average exercise price
\$ 4.88 - \$ 6.31	112,500	9.2	\$ 5.30	27,500	\$ 5.26
	112,500	9.2	\$ 5.30	27,500	\$ 5.26

As of December 31, 2014, there was \$260,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Employee Plan. 44,000 options were granted during the three and

six months ended December 31, 2014. The total fair value of the options vesting during the three and six months ended December 31, 2014 and 2013 under this plan was \$25,000 and \$37,000, respectively and \$41,000 and \$60,000, respectively.

#### 2012 Non-Employee Stock Option Plan

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, 2014, 35,000 stock options were granted, 12,000 stock options were exercisable and 15,000 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	2.3%
Expected lives	10 years
Expected volatility	54%
Expected dividend yields	0%

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

	2014		2013	
	Options	Weighted average exercise price	Options	Weighted average exercise price
Outstanding, beginning of year	25,000	\$ 4.88	—	\$ —
Granted	10,000	4.37	25,000	4.88
Terminated/Lapsed	—	—	—	—
Exercised	—	—	—	—
Outstanding, end of period	35,000	\$ 4.73	25,000	\$ 4.88
Exercisable, end of period	12,000	\$ 4.80	5,000	\$ 4.88
Weighted average fair value at grant date of options granted	\$2.86		\$3.30	
Total intrinsic value of options exercised	n/a		n/a	
Total intrinsic value of options outstanding	\$3,000		\$35,000	
Total intrinsic value of options exercisable	\$1,000		\$7,000	

The following table summarizes information about stock options outstanding under the 2012 Non-Employee Plan at December 31, 2014:

Range of exercise prices	Options outstanding		Weighted average exercise	Options exercisable	
	Number outstanding	Weighted average remaining		Number exercisable	Weighted average exercise

		contractual life	price		price
\$4.37 - \$ 4.88	35,000	9.0	\$ 4.73	12,000	\$ 4.80
	35,000	9.0	\$ 4.73	12,000	\$ 4.80

As of December 31, 2014, there was \$72,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Non-Employee Plan. 10,000 options were granted during the three and six months ended December 31, 2014. The total fair value of the options vesting during each of the three and six month periods ended December 31, 2014 and 2013 under this plan was \$6,000 and \$17,000, respectively and \$22,000 and \$17,000, respectively.

#### 2002 Employee Stock Option Plan

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, 2014, 1,471,480 stock options had been granted, 264,750 stock options were exercisable and no further stock options were available for grant under this plan after the plans expiration in October 2012.

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

	2014	Weighted average exercise price	2013	Weighted average exercise price
	Options		Options	
Outstanding, beginning of year	265,750	\$ 6.51	651,140	\$ 4.18
Granted	—	—	—	—
Terminated/Lapsed	(1,000 )	6.02	(30,240 )	1.74
Exercised	—	—	(326,800)	2.70
Outstanding, end of period	264,750	\$ 6.51	294,100	\$ 6.07
Exercisable, end of period	264,750	\$ 6.51	294,100	\$ 6.07
Weighted average fair value at grant date of options granted	n/a		n/a	
Total intrinsic value of options exercised	n/a		\$854,000	
Total intrinsic value of options outstanding	\$—		\$254,000	
Total intrinsic value of options exercisable	\$—		\$254,000	

0 and 326,800 stock options were exercised during the six months ended December 31, 2014 and 2013, respectively. 324,100 of the 326,800 stock options exercised during the six months ended December 31, 2013 were settled by exchanging 164,859 shares of the Company's common stock of which 85,170 was retired upon receipt. Cash received from option exercises was \$0 and \$5,000 for the six months ended December 31, 2014 and 2013, 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, 2014:

Range of exercise prices	Options outstanding and exercisable		Weighted average exercise price
	Number outstanding	Weighted average remaining contractual life	
\$ 5.22 - \$ 6.62	227,250	1.3	\$ 5.75
\$11.16	37,500	1.2	11.16
	264,750	1.3	\$ 6.51

#### NOTE 8 – Stockholders' Equity Transactions

On September 16, 2014 the Company's board of directors authorized the repurchase of up to 1 million of the approximately 19.4 million shares of the Company's common stock outstanding. The repurchase will be made from

time to time in the open market or in privately negotiated transactions subject to market conditions and the market price of the common stock. Relative to the Loan Agreement described in Note 6, the Company's lender gave its consent to this stock repurchase plan. During the six months ended December 31, 2014 the Company repurchased 304,186 shares of its outstanding common stock for a weighted average price of \$4.55 per share. These repurchased shares are included in the Company's Treasury Stock as of December 31, 2014.

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 \$41,000 and \$25,000 for the three months ended December 31, 2014 and 2013, respectively and \$67,000 and \$51,000 for the six months ended December 31, 2014 and 2013, 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 \$9,000 for the three months ended December 31, 2014 and 2013, respectively and \$16,000 and \$18,000 for the six months ended December 31, 2014 and 2013, 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 December 31, 2014, 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 2016 and provides for an annual salary of \$296,900, a bonus arrangement for fiscal 2015 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 access control systems, door security products, intrusion and fire alarm systems and video surveillance products 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.

## Financial Information Relating to Domestic and Foreign Operations

	Three months ended December 31,		Six months ended December 31,	
	2014	2013	2014	2013
	(in thousands)		(in thousands)	
Sales to external customers(1):				
Domestic	\$ 18,876	\$ 17,593	\$ 35,448	\$ 33,887
Foreign	695	760	1,459	1,705
Total Net Sales	\$ 19,571	\$ 18,353	\$ 36,907	\$ 35,592

Identifiable assets:	December 31, 2014	June 30, 2014
United States	\$ 47,553	\$ 49,529
Dominican Republic (2)	14,127	13,835
Total Identifiable Assets	\$ 61,680	\$ 63,364

(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, 2014 = \$10,477; June 30, 2014 = \$10,216) and fixed assets (December 31, 2014 = \$3,425; June 30, 2014 = \$3,475) 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, 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 and distribution problems. The Company's Risk Factors are discussed in more detail in Item 1A in the Company's 2014 Annual Report on Form 10-K.

## Overview

The Company is a diversified manufacturer of security products, encompassing access control systems, door security products, intrusion and fire alarm systems and video surveillance products for commercial and residential use. 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 4% and 5% of our revenues for the six month periods ended December 31, 2014 and 2013, 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 or thereafter 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 2014 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 two customers with accounts receivable balance that aggregated 23% of the Company's accounts receivable at December 31, 2014. The Company had one customer with an accounts receivable balance that comprised 12% of the Company's accounts receivable at June 30, 2014. 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 \$160,000 and \$180,000 as of December 31, 2014 and June 30, 2014, 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 and will evaluate them earlier if there are indicators of a potential impairment. 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, (dollars in thousands)			
	2014	2013	% Increase/ (decrease)	2014	2013	% Increase/ (decrease)	
Net sales	\$ 19,571	\$ 18,353	6.6 %	\$ 36,907	\$ 35,592	3.7 %	
Gross profit	6,103	5,081	20.1 %	11,358	10,120	12.2 %	
Gross profit as a % of net sales	31.2 %	27.7 %	12.6 %	30.8 %	28.4 %	8.5 %	
Selling, general and administrative	5,007	4,577	9.4 %	10,016	9,376	6.8 %	
Selling, general and administrative as a percentage of net sales	25.6 %	24.9 %	2.8 %	27.1 %	26.3 %	3.0 %	
Operating income	1,096	504	117.5 %	1,342	744	80.4 %	
Interest expense, net	54	80	(32.5 )%	109	179	(39.1 )%	
Other (income) expense	3	4	(25.0 )%	(2 )	7	(128.6 )%	
Provision for income taxes	88	52	69.2 %	125	67	86.6 %	
Net income	951	368	158.4 %	1,110	491	126.1 %	

Sales for the three months ended December 31, 2014 increased by \$1,218,000 to \$19,571,000 as compared to \$18,353,000 for the same period a year ago. Sales for the six months ended December 31, 2014 increased by \$1,315,000 to \$36,907,000 as compared to \$35,592,000 for the same period a year ago. The increase in sales for the three months ended December 31, 2014 was due primarily to increased sales of the Company's door-locking products (\$136,000), intrusion products (\$586,000), and access control products (\$495,000). The increase in sales for the six months ended December 31, 2014 was due primarily to increased sales of the Company's door-locking products (\$508,000), intrusion products (\$631,000), and access control products (\$175,000). Intrusion sales in the three months ended December 31, 2013 were impacted by a temporary delay in processing orders from a large distributor. This did not occur in the three months ended December 31, 2014. The increase in sales of access control products in the quarter ended December 31, 2014 was due primarily to the shipment of a \$410,000 order for a major college.

Gross profit for the three months ended December 31, 2014 increased to \$6,103,000 or 31.2% of sales as compared to \$5,081,000 or 27.7% of sales for the same period a year ago. Gross profit for the six months ended December 31, 2014 increased to \$11,358,000 or 30.8% of sales as compared to \$10,120,000 or 28.4% of sales for the same period a year ago. The increase in gross profit for the three and six months was primarily due to increased sales as well as a continued positive shift in product mix to the Company's door-locking products.

Selling, general and administrative expenses for the three months ended December 31, 2014 increased by \$430,000 to \$5,007,000 from 4,577,000 for the same period a year ago. Selling, general and administrative expenses for the six months ended December 31, 2014 increased by \$640,000 to \$10,016,000 from 9,376,000 for the same period a year ago. Selling, general and administrative expenses as a percentage of net sales increased to 25.6% for the three months ended December 31, 2014 from 24.9% for the same period a year ago. Selling, general and administrative expenses as a percentage of net sales increased to 27.1% for the six months ended December 31, 2014 from 26.3% for the same period a year ago. The increase in dollars for the three months was due primarily from the addition of selling personnel and increased media advertising.

Interest expense, net for the three months ended December 31, 2014 decreased by \$26,000 to \$54,000 as compared to \$80,000 for the same period a year ago. Interest expense, net for the six months ended December 31, 2014 decreased by \$70,000 to \$109,000 as compared to \$179,000 for the same period a year ago. The decrease in interest expense for the three and six months ended December 31, 2014 resulted from lower average outstanding debt and lower interest rates during the current periods as compared to the same periods a year ago.

The Company's provision for income taxes for the three months ended December 31, 2014 increased by \$36,000 to \$88,000 as compared to \$52,000 for the same period a year ago. The Company's provision for income taxes for the six months ended December 31, 2014 increased by \$58,000 to \$125,000 as compared to \$67,000 for the same period a year ago. The change in the provision for income taxes were caused primarily by the increase in income before income taxes as offset by a change in the proportion of the income before income taxes being generated by the Company's U.S. operations to the income being generated by non-taxable foreign operations for the three and six months ended December 31, 2014 as compared to the same period a year ago. As a result, the Company's effective rate for income tax was 8% and 12% for the three months ended December 31, 2014 and 2013, respectively and 10% and

12% for the six months ended December 31, 2014 and 2013, respectively.

Net income increased by \$583,000 to \$951,000 or \$0.05 per diluted share for the three months ended December 31, 2014 as compared to \$368,000 or \$0.02 per diluted share for the same period a year ago. Net income increased by \$619,000 to \$1,110,000 or \$0.06 per diluted share for the six months ended December 31, 2014 as compared to \$491,000 or \$0.03 per diluted share for the same period a year ago. The increase in net income for the three and six months ended December 31, 2014 was primarily due to the items as described above.

### Liquidity and Capital Resources

During the six months ended December 31, 2014 the Company utilized its cash from operations (\$1,740,000) and a portion of its cash on-hand at June 30, 2014 (\$773,000 of \$2,483,000) to repay outstanding debt (\$800,000), purchase treasury stock (\$1,390,000) and purchase property, plant and equipment (\$323,000). 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, 2014 decreased \$1,552,000 to \$15,352,000 as compared to \$16,904,000 at June 30, 2014. This decrease is primarily the result of the lower sales volume during the quarter ended December 31, 2014 as compared to the quarter ended June 30, 2014, which is typically the Company's highest.

Inventories at December 31, 2014 increased \$1,083,000 to \$26,093,000 as compared to \$25,010,000 at June 30, 2014. This increase is primarily the result of the Company level-loading its production facility in the Dominican Republic, whereas the Company's sales are typically highest in the fourth quarter.

Accounts payable, accrued expenses and accrued income taxes decreased \$705,000 to \$7,107,000 as of December 31, 2014 as compared to \$7,812,000 at June 30, 2014.

As of December 31, 2014, 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, 2014, the Company had \$2,500,000 in outstanding borrowings and \$8,500,000 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, 2014 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, 2014, an aggregate principal amount of approximately \$11,000,000 was outstanding under the Company's credit facilities with a weighted average interest rate of approximately 1.7%. 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 \$110,000 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 increase 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, 2014, 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, 2014.

During the three months ended December 31, 2014, 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, 2014. 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, 2014 during the three months ended December 31, 2014.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under Plans or Programs
October 1, 2014 - October 31, 2014	87,944	\$ 4.42	87,944	804,500
November 1, 2014 – November 30, 2014	61,650	\$ 4.44	61,650	742,850
December 1, 2014 – December 31, 2014	47,036	\$ 4.55	47,036	695,814
Total for the Quarter ended December 31, 2014	196,630	\$ 4.45	196,630	695,814

On September 16, 2014 the Company's board of directors authorized the repurchase of up to 1 million of the approximately 19.4 million shares of the Company's common stock then outstanding. The repurchase will be made from time to time in the open market or in privately negotiated transactions subject to market conditions and the market price of the common stock.

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.CALXBRL Taxonomy Extension Calculation Linkbase Document  
101.LABXBRL Taxonomy Extension Label Linkbase Document  
101.PRE XBRL Taxonomy Extension Presentation Linkbase Document  
101.DEF XBRL Taxonomy Extension Definition Linkbase Document

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 9, 2015

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

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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