

NAPCO SECURITY TECHNOLOGIES, INC
Form 10-Q
November 07, 2016

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
^X ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED: **SEPTEMBER 30, 2016**
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)

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: November 4, 2016

| | |
|---|------------|
| COMMON STOCK, \$.01 PAR VALUE PER SHARE | 18,798,838 |
|---|------------|

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2016 (unaudited) (in thousands, except for share data) | June 30, 2016 (audited) |
|---|---|----------------------------|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 4,715 | \$ 3,805 |
| Accounts receivable, net of reserves and allowances | 17,311 | 19,012 |
| Inventories | 21,792 | 21,428 |
| Prepaid expenses and other current assets | 920 | 936 |
| Deferred income taxes | 698 | 703 |
| Total Current Assets | 45,436 | 45,884 |
| Inventories - non-current | 4,012 | 3,909 |
| Deferred income taxes | 401 | 436 |
| Property, plant and equipment, net | 5,974 | 6,049 |
| Intangible assets, net | 8,247 | 8,357 |
| Other assets | 176 | 134 |
| TOTAL ASSETS | \$ 64,246 | \$ 64,769 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES | | |
| Current maturities of long term debt | \$ 300 | \$ 300 |
| Accounts payable | 4,220 | 4,328 |
| Accrued expenses | 1,783 | 1,893 |
| Accrued salaries and wages | 2,405 | 2,467 |
| Accrued income taxes | 39 | 8 |
| Total Current Liabilities | 8,747 | 8,996 |
| Long-term debt, net of current maturities | 3,625 | 4,500 |
| Total Liabilities | 12,372 | 13,496 |

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' EQUITY

| | | | | |
|---|------------------|---|------------------|---|
| Common Stock, par value \$0.01 per share; 40,000,000 shares authorized; 21,116,743 and 21,116,743 shares issued; and 18,786,893 and 18,786,893 shares outstanding, respectively | 211 | | 211 | |
| Additional paid-in capital | 16,655 | | 16,622 | |
| Retained earnings | 46,740 | | 46,172 | |
| | 63,606 | | 63,005 | |
| Less: Treasury Stock, at cost (2,329,850 and 2,329,850 shares, respectively) | (11,732 |) | (11,732 |) |
| TOTAL STOCKHOLDERS' EQUITY | 51,874 | | 51,273 | |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 64,246 | | \$ 64,769 | |

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

| | Three months ended September 30, | |
|--|---|------------|
| | 2016 | 2015 |
| | (In thousands, except share and per share data) | |
| Net sales | \$ 20,168 | \$ 18,149 |
| Cost of sales | 13,716 | 12,512 |
| Gross Profit | 6,452 | 5,637 |
| Selling, general, and administrative expenses | 5,736 | 5,313 |
| Operating Income | 716 | 324 |
| Other expense: | | |
| Interest, net | 24 | 53 |
| Income before Income Taxes | 692 | 271 |
| Income tax expense (benefit) | 124 | (44) |
| Net Income | \$ 568 | \$ 315 |
| Net Income per share: | | |
| Basic | \$ 0.03 | \$ 0.02 |
| Diluted | \$ 0.03 | \$ 0.02 |
| Weighted average number of shares outstanding: | | |
| Basic | 18,787,000 | 18,965,000 |
| Diluted | 18,838,000 | 18,986,000 |

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

| | Three months ended September 30, | |
|---|----------------------------------|----------|
| | 2016 | 2015 |
| | (in thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net Income | \$ 568 | \$ 315 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 322 | 344 |
| Provision for doubtful accounts | (5) | (75) |
| Deferred income taxes | 40 | (11) |
| Stock based compensation expense | 33 | 32 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,706 | 2,800 |
| Inventories | (467) | (910) |
| Prepaid expenses and other current assets | 16 | 89 |
| Income tax receivable | — | (23) |
| Other assets | (45) | — |
| Accounts payable, accrued expenses and accrued income taxes | (249) | (474) |
| Net Cash Provided by Operating Activities | 1,919 | 2,087 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of property, plant, and equipment | (134) | (133) |
| Net Cash Used in Investing Activities | (134) | (133) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Principal payments on long-term debt | (875) | (1,400) |
| Cash paid for purchase of treasury stock | — | (94) |
| Net Cash Used in Financing Activities | (875) | (1,494) |
| Net Increase in Cash and Cash Equivalents | 910 | 460 |
| CASH AND CASH EQUIVALENTS - Beginning | 3,805 | 2,346 |
| CASH AND CASH EQUIVALENTS - Ending | \$ 4,715 | 2,806 |
| SUPPLEMENTAL CASH FLOW INFORMATION | | |
| Interest paid, net | \$ 29 | \$ 52 |
| Income taxes paid | \$ 53 | \$ — |

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2016

Nature of Business:

Napco Security Technologies, Inc. and Subsidiaries (the "Company") is a diversified manufacturer of security products, encompassing access control systems, door-locking 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:

Principles of Consolidation

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, 2016 and the notes thereto included in the Company's Annual Report on Form 10-K filed with the SEC on September 8, 2016. 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 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 September 30, 2016 due to their short-term maturities; Long-Term Debt - The carrying amount of the Company's long-term debt, including the current portion, at September 30, 2016 in the amount of \$3,925,000 approximates fair value.

Cash and Cash Equivalents

Cash and cash equivalents include approximately \$460,000 of short-term time deposits at September 30, 2016 and June 30, 2016. 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 September 30, 2016 and June 30, 2016. 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 \$140,000 and \$145,000 and for returns and other allowances of \$1,186,000 and \$1,255,000 as of September 30, 2016 and June 30, 2016, 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 our accounts receivable aging, 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):

| | September 30, 2016 | | | June 30, 2016 | | |
|------------------------|--------------------|--------------------------|----------------|---------------|--------------------------|----------------|
| | Cost | Accumulated amortization | Net book value | Cost | Accumulated amortization | Net book value |
| Customer relationships | \$9,800 | \$ (7,453) | \$ 2,347 | \$9,800 | \$ (7,343) | \$ 2,457 |
| Trade name | 5,900 | — | 5,900 | 5,900 | — | 5,900 |
| | \$15,700 | \$ (7,453) | \$ 8,247 | \$15,700 | \$ (7,343) | \$ 8,357 |

Amortization expense for intangible assets subject to amortization was approximately \$110,000 and \$137,000 for the three months ended September 30, 2016 and 2015, respectively. Amortization expense for each of the next five fiscal years is estimated to be as follows: 2017 - \$441,000; 2018 - \$371,000; 2019 - \$313,000 and 2020 - \$264,000 and 2021 - \$223,000. The weighted average amortization period for intangible assets was 11.9 years and 12.9 years at September 30, 2016 and 2015, 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 or service, (iii) shipment and passage of title occurs or service has been provided, 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. Revenues for services are recorded at the time the service is provided to the customer pursuant to the terms of 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 9% and 7% for the three months ended September 30, 2016 and 2015, 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 September 30, 2016 and 2015 was \$674,000 and \$558,000, respectively.

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 September 30, 2016 and 2015 was \$1,628,000 and \$1,489,000, 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 September 30 (in thousands, except per share data):

| | Net Income | | Weighted Average Shares | | Net Income per Share | |
|--------------------------------|------------|-------|-------------------------|--------|----------------------|---------|
| | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 |
| Basic EPS | \$568 | \$315 | 18,787 | 18,965 | \$ 0.03 | \$ 0.02 |
| Effect of Dilutive Securities: | | | | | | |
| Stock Options | — | — | 51 | 21 | — | — |
| Diluted EPS | \$568 | \$315 | 18,838 | 18,986 | \$ 0.03 | \$ 0.02 |

Options to purchase 0 and 170,000 shares of common stock for the three months ended September 30, 2016 and 2015, 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 \$33,000 and \$32,000 was recognized for the three months ended September 30, 2016 and 2015, respectively. The effect on both Basic and Diluted Earnings per share was \$0.00 for each of the three months ended September 30, 2016 and 2015.

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 months ended September 30, 2016 and 2015.

Comprehensive Income

For the three months ended September 30, 2016 and 2015, 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 (\$139,000 and \$131,000 in the three months ended September 30, 2016 and 2015, respectively) and classifies the costs associated with these revenues in cost of sales (\$216,000 in each of the three months ended September 30, 2016 and 2015).

Recently Issued Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") issued authoritative guidance that changes the way companies account for certain aspects of share-based payments to employees. The most significant impact relates to the accounting for income tax effects of share-based compensation awards. This new guidance is part of the FASB's simplification initiative and requires that all excess tax benefits and tax deficiencies be recorded as income tax expense or benefit in the income statement. In addition, companies are required to treat the tax effects of exercised or vested awards as discrete items in the period that they occur. Other updates include changing the threshold on tax withholding requirements. Under this guidance, an employer can withhold up to the maximum statutory withholding rates in a jurisdiction without tainting the award classification. Additionally, this guidance allows companies to elect a forfeiture recognition method whereby they account for forfeitures as they occur (actual) or they estimate the number of awards expected to be forfeited (current GAAP). Lastly, as it relates to public entities, this guidance also provides requirements for the cash flow classification of cash paid by an employer when directly withholding shares for tax-withholding purposes and excess tax benefits. This guidance becomes effective for the Company's fiscal 2018 first quarter, with early adoption permitted, and the guidance prescribes different transition methods for the various provisions (i.e., retrospective, modified retrospective, or prospective). The Company is currently evaluating the impact of applying this guidance on its consolidated financial statements.

In February 2016, the FASB issued authoritative guidance that requires lessees to account for most leases on their balance sheets with the liability being equal to the present value of the lease payments. The right-of-use asset will be based on the lease liability adjusted for certain costs such as direct costs. Lease expense will be recognized similar to current accounting guidance with operating leases resulting in a straight-line expense and financing leases resulting in a front-loaded expense similar to the current accounting for capital leases. This guidance becomes effective for the Company's fiscal 2020 first quarter, with early adoption permitted. This guidance must be adopted using a modified

retrospective transition approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, and provides for certain practical expedients. The Company is currently evaluating the timing, impact and method of applying this guidance on its consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17 “Balance Sheet Classification of Deferred Taxes”. The amendments require deferred tax assets and liabilities, along with related valuation allowances, to be classified as noncurrent on the balance sheet. As a result, each tax jurisdiction will now only have one net noncurrent deferred tax asset or liability. The new guidance does not change the existing requirement that prohibits offsetting deferred tax liabilities from one jurisdiction against deferred tax assets of another jurisdiction. ASU 2015-17 is effective for the Company’s fiscal year ended June 30, 2018. Early application is permitted. We have not early adopted ASU 2015-17. The new guidance must be applied prospectively after the date of adoption. We have evaluated the adoption of this ASU, and do not expect this to have a material effect on our consolidated results of operations and financial condition.

In July 2015, the FASB issued ASU 2015-11 “Inventory (Topic 330): Simplifying the Measurement of Inventory” (ASU 2015-11). The amendments in ASU 2015-11 simplify the subsequent measurement of inventory by requiring inventory to be measured at the lower of cost and net realizable value. ASU 2015-11 is effective for the Company’s quarter ended September 30, 2017. Early application is permitted. We have not early adopted ASU 2015-11. The new guidance must be applied prospectively after the date of adoption. We are in the process of evaluating the adoption of this ASU, and do not expect this to have a material effect on our consolidated results of operations and financial condition.

In May 2014, the FASB issued authoritative guidance that defines how companies should report revenues from contracts with customers. The standard requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. It provides companies with a single comprehensive five-step principles-based model to use in accounting for revenue and supersedes current revenue recognition requirements, including most industry-specific and transaction-specific revenue guidance. In August 2015, the FASB deferred the effective date of the new revenue standard by one year. As a result, the new standard would not be effective for the Company until fiscal 2019. In addition, the FASB is allowing companies to early adopt this guidance for the Company’s fiscal 2018. The guidance permits an entity to apply the standard retrospectively to all prior periods presented, with certain practical expedients, or apply the requirements in the year of adoption, through a cumulative adjustment. The Company will apply this new guidance when it becomes effective and has not yet selected a transition method. The Company is currently evaluating the impact of adoption on its consolidated financial statements.

NOTE 2 - Business and Credit Concentrations

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 an accounts receivable balance that comprised 25% and 22% of the Company’s accounts receivable at September 30, 2016 and June 30, 2016, respectively. Sales to this customer comprised 14% and 9% of net sales in each of the three months ended September 30, 2016 and 2015.

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):

| | September 30, 2016 | June 30, 2016 |
|------------------|-----------------------|------------------|
| Component parts | \$ 14,279 | \$ 14,021 |
| Work-in-process | 3,828 | 3,758 |
| Finished product | 7,697 | 7,558 |
| | \$ 25,804 | \$ 25,337 |

Classification of inventories, net of reserves:

| | | |
|-------------|----------|----------|
| Current | \$21,792 | \$21,428 |
| Non-current | 4,012 | 3,909 |
| | \$25,804 | \$25,337 |

NOTE 4 – Property, Plant and Equipment

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

| | September 30, 2016 | June 30, 2016 | Useful Life in Years |
|---|--------------------------|------------------|--|
| Land | \$904 | \$904 | — |
| Buildings | 8,912 | 8,911 | 30 to 40 |
| Molds and dies | 7,050 | 7,036 | 3 to 5 |
| Furniture and fixtures | 2,531 | 2,531 | 5 to 10 |
| Machinery and equipment | 21,140 | 21,035 | 7 to 10 |
| Leasehold improvements | 294 | 294 | Shorter of the lease term or life of asset |
| | 40,831 | 40,711 | |
| Less: accumulated depreciation and amortization | 34,857 | 34,662 | |
| | \$5,974 | \$6,049 | |

Depreciation and amortization expense on property, plant, and equipment was \$195,000 and \$205,000 for the three months ended September 30, 2016 and 2015, 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 September 30, 2016 we remain subject to examination in all tax jurisdictions for all relevant jurisdictional statutes for fiscal years 2013 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.

NOTE 6 - Long-Term Debt

As of September 30, 2016, long-term debt consisted of a revolving credit facility of \$11,000,000 (the "Revolving Credit Facility") which expires in June 2021 and one loan for \$6,000,000 which expires in June 2019 (the "Term Loan"). The Revolving Credit Facility had an expiration date of June 2017 which was extended to June 2021 at the end of fiscal 2016. Repayment of the Term Loan commenced on September 30, 2012. The Term Loan is being repaid with 28 equal, quarterly payments of \$75,000 plus any additional payments made at the Company's discretion with the remaining balance of \$1,100,000 due on or before the expiration date.

Outstanding balances and interest rates as of September 30, 2016 and June 30, 2016 are as follows:

| | September 30, 2016 | | June 30, 2016 | |
|--------------------------|--------------------|---------------|---------------|---------------|
| | Outstanding | Interest Rate | Outstanding | Interest Rate |
| Revolving line of credit | \$ 2,000 | 1.7 % | \$ 2,000 | 1.6 % |
| Term loans | 1,925 | 1.7 % | 2,800 | 1.6 % |
| Total debt | \$ 3,925 | 1.7 % | \$ 4,800 | 1.6 % |

The Revolving Credit Facility and Term Loans (collectively the “Agreement”) also provides for a LIBOR-based interest rate option of LIBOR plus 1.15% to 2.00%, 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, and 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 September 30, 2016 and 2015, the Company recorded non-cash compensation expense of \$33,000 (\$.00 per basic and diluted share) and \$32,000 (\$.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 September 30, 2016, 112,500 stock options were granted, 60,700 stock options were exercisable and 837,500 stock options were available for grant under this plan.

The following table reflects activity under the 2012 Plan for the three months ended September 30,:

| | 2016 | | 2015 | |
|--|-----------|---------------------------------|-----------|---------------------------------|
| | Options | Weighted average exercise price | Options | Weighted average exercise price |
| Outstanding, beginning of year | 112,500 | \$ 5.54 | 112,500 | \$ 5.30 |
| Granted | — | — | — | — |
| Terminated/Lapsed | — | — | (15,000) | 4.29 |
| Exercised | — | — | — | — |
| Outstanding, end of period | 112,500 | \$ 5.54 | 97,500 | \$ 5.46 |
| Exercisable, end of period | 60,700 | \$ 5.55 | 29,500 | \$ 5.33 |
| 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 | \$186,000 | | \$69,000 | |
| Total intrinsic value of options exercisable | \$100,000 | | \$24,000 | |

The following table summarizes information about stock options outstanding under the 2012 Employee Plan at September 30, 2016:

| Range of exercise prices | Options outstanding | | | Options exercisable | |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
| | Number outstanding | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable | Weighted average exercise price |
| \$4.29-\$6.31 | 112,500 | 7.7 | \$ 5.54 | 60,700 | \$ 5.55 |
| | 112,500 | 7.7 | \$ 5.54 | 60,700 | \$ 5.55 |

As of September 30, 2016, there was \$186,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Employee Plan. No options were granted during the three months ended September 30, 2016. The total fair value of the options vesting during each of the three months ended September 30, 2016 and 2015 under this plan was \$16,000.

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 September 30, 2016, 35,000 stock options were granted, 24,000 stock options were exercisable and 15,000 stock options were available for grant under this plan.

The following table reflects activity under the 2012 Non-Employee Plan for the three months ended September 30,:

| 2016 Options | 2015 Options |
|-----------------|-----------------|
|-----------------|-----------------|

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| | | Weighted average exercise price | | Weighted average exercise price |
|--|----------|---------------------------------------|----------|---------------------------------------|
| Outstanding, beginning of year | 35,000 | \$ 4.73 | 35,000 | \$ 4.73 |
| Granted | — | — | — | — |
| Terminated/Lapsed | — | — | — | — |
| Exercised | — | — | — | — |
| Outstanding, end of period | 35,000 | \$ 4.73 | 35,000 | \$ 4.73 |
| Exercisable, end of period | 24,000 | \$ 4.80 | 17,000 | \$ 4.82 |
| 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 | \$86,000 | | \$46,000 | |
| Total intrinsic value of options exercisable | \$57,000 | | \$21,000 | |

The following table summarizes information about stock options outstanding under the 2012 Non-Employee Plan at September 30, 2016:

| Range of exercise prices | Options outstanding | | | Options exercisable | |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
| | Number outstanding | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable | Weighted average exercise price |
| \$4.37 - \$4.88 | 35,000 | 7.3 | \$ 4.73 | 24,000 | \$ 4.80 |
| | 35,000 | 7.3 | \$ 4.73 | 24,000 | \$ 4.80 |

As of September 30, 2016, there was \$34,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Non-Employee Plan. No options were granted during the three months ended September 30, 2016. The total fair value of the options vesting during each of the three months ended September 30, 2016 and 2015 under this plan was \$16,000.

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 September 30, 2016, 1,471,480 stock options had been granted and 140,000 stock options were exercisable. 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 three months ended September 30,:

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| | 2016 | Weighted average exercise price | 2015 | Weighted average exercise price |
|--|-----------|---------------------------------------|----------|---------------------------------------|
| | Options | | Options | |
| Outstanding, beginning of year | 102,500 | \$ 6.86 | 208,500 | \$ 6.86 |
| Granted | — | — | — | — |
| Terminated/Lapsed | — | — | — | — |
| Exercised | — | — | — | — |
| Outstanding, end of period | 102,500 | \$ 6.86 | 208,500 | \$ 6.86 |
| Exercisable, end of period | 102,500 | \$ 6.86 | 208,500 | \$ 6.86 |
| 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 | \$118,000 | | \$37,000 | |
| Total intrinsic value of options exercisable | \$118,000 | | \$37,000 | |

No stock options were exercised during either of the three months ended September 30, 2016 and 2015. No cash was received from option exercises during either of the three months ended September 30, 2016 and 2015 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 September 30, 2016:

| Range of exercise prices | Options outstanding and exercisable | | Weighted average exercise price |
|--------------------------|-------------------------------------|---|---------------------------------|
| | Number outstanding | Weighted average remaining contractual life | |
| \$5.35 - \$6.62 | 102,500 | 0.4 | \$ 6.04 |
| | 102,500 | 0.4 | \$ 6.04 |

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. No shares were purchased under this plan during the three months ended September 30, 2016.

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 \$28,000 and \$28,000 for the three months ended September 30, 2016 and 2015, 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 2019.

Rent expense, with the exception of the land lease referred to below, totaled approximately \$6,000 and \$7,000 for the three months ended September 30, 2016 and 2015, 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 September 30, 2016, the Company was obligated under three employment agreements and one severance agreement. The employment agreements are with the Company's CEO, Senior Vice President of Sales and Marketing ("the SVP of Sales") and the Senior Vice President of Engineering ("the SVP of Engineering"). The employment agreement with the CEO provides for an annual salary of \$670,000, 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 of Sales expires in October 2017 and provides for an annual salary of \$315,000, a bonus arrangement for fiscal 2016 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 employment agreement with the SVP of Engineering expires in August 2018 and provides for an annual salary of \$285,000, a bonus arrangement and, if terminated by the Company without cause, severance of nine month's salary and continued company-sponsored health insurance for six months from the date of termination. The severance agreement is with the Senior Vice President of Operations and Finance and provides for, if terminated by the Company without cause or within three months of a change in corporate control of the Registrant, severance of nine month's salary, continued company-sponsored health insurance for six months from the date of termination and certain non-compete and other restrictive provisions. Each

of the severance agreements with the SVP of Sales, the SVP of Engineering and the Senior Vice President of Operations and Finance contains non-compete restrictions for three years after the employee's termination of employment.

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 September 30, | |
|---------------------------------|----------------------------------|-----------|
| | 2016 | 2015 |
| | (in thousands) | |
| Sales to external customers(1): | | |
| Domestic | \$ 19,493 | \$ 17,557 |
| Foreign | 675 | 592 |
| Total Net Sales | \$ 20,168 | \$ 18,149 |

| Identifiable assets: | September 30, 2016 | June 30, 2016 |
|---------------------------|-----------------------|---------------|
| United States | \$50,148 | \$51,272 |
| Dominican Republic (2) | 14,098 | 13,497 |
| Total Identifiable Assets | \$64,246 | \$64,769 |

(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 (September 30, 2016 = \$10,666, June 30, 2016 = \$10,076) and fixed assets (September 30, 2016 = \$3,223, June 30, 2016 = \$3,311) 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, our ability to maintain and develop competitive products, adverse tax consequences of offshore operations, the ability to maintain adequate financing and significant fluctuations in the exchange rate between the Dominican Peso and the U.S. Dollar. The Company's Risk Factors are discussed in more detail in Item 1A in the Company's 2016 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 3% of our revenues for each of the three months ended September 30, 2016 and 2015.

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 may contribute to increasing profit margins. Conversely, when production levels decline our fixed costs are spread over reduced levels, which may contribute to 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 2017 to contribute materially to revenue during fiscal 2017, 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 2016 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 or service, (iii) shipment and passage of title occurs or service has been provided, 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. Revenues for services are recorded at the time the service is provided to the customer pursuant to the terms of 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 an accounts receivable balance that comprised 25% and 22% of the Company's accounts receivable at September 30, 2016 and June 30, 2016, respectively. Sales to this customer comprised 14% and 9% of net sales in each of the three months ended September 30, 2016 and 2015.

In the ordinary course of business, we have established a reserve for doubtful accounts and customer deductions in the amount of \$140,000 and \$145,000 as of September 30, 2016 and June 30, 2016, 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 if there is 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

The Company has identified the United States and New York State as its major tax jurisdictions. The fiscal 2012 and forward years are still open for examination.

For the three months ended September 30, 2016, the Company recognized a net income tax expense of \$124,000. During the three months ended September 30, 2016 the Company increased its reserve for uncertain income tax positions by \$29,000. The Company's practice is to recognize interest and penalties related to income tax matters in income tax expense and accrued income taxes. As of September 30, 2016, the Company had accrued interest totaling \$0 and \$177,000 of unrecognized net tax benefits that, if recognized, would favorably affect the Company's effective income tax rate in any future period. The Company uses the flow through method to account for investment tax credits earned on eligible research and development expenditures. Under this method, the investment tax credits are recognized as a reduction to income tax expense.

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 September 30, (dollars in thousands) | | | |
|--|--|-----------|---------------------------|----|
| | 2016 | 2015 | % Increase/ (decrease) | |
| Net sales | \$ 20,168 | \$ 18,149 | 11.1 | % |
| Gross profit | 6,452 | 5,637 | 14.5 | % |
| Gross profit as a % of net sales | 32.0 | % 31.1 | 2.9 | % |
| Selling, general and administrative | 5,736 | 5,313 | 8.0 | % |
| Selling, general and administrative as a percentage of net sales | 28.4 | % 29.3 | (3.1) |)% |
| Operating income | 716 | 324 | 121.0 | % |

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| | | | | |
|--------------------------------------|-----|-----|-------|-------|
| Interest expense, net | 24 | 53 | (54.7 |)% |
| Provision (benefit) for income taxes | 124 | (44 |) | 381.8 |
| Net income | 568 | 315 | 80.3 | % |

Sales for the three months ended September 30, 2016 increased by \$2,019,000 to \$20,168,000 as compared to \$18,149,000 for the same period a year ago. The increase in sales for the three months ended September 30, 2016 was due primarily to increased sales of the Company's intrusion products (\$1,384,000) and door-locking products (\$803,000) as partially offset by decreased sales of access control products (\$168,000). Sales of the Company's intrusion products increased primarily from increased sales of its wireless products. Sales of the Company's door-locking products increased primarily from an increase in commercial and industrial installations of the Company's digital lock products.

Gross profit for the three months ended September 30, 2016 increased to \$6,452,000 or 32.0% of sales as compared to \$5,637,000 or 31.1% of sales for the same period a year ago. The increase in gross profit for the three months was primarily due to the increases in sales as partially offset by higher Research and Development expenditures.

Selling, general and administrative expenses for the three months ended September 30, 2016 increased by \$423,000 to \$5,736,000 from \$5,313,000 for the same period a year ago. Selling, general and administrative expenses as a percentage of net sales decreased to 28.4% for the three months ended September 30, 2016 from 29.3% for the same period a year ago. The decrease as a percentage of sales is due primarily to the increase in net sales as partially offset by the increase in dollars. The increase in dollars for the three months was due primarily from increased advertising and the addition of selling personnel.

Interest expense, net for the three months ended September 30, 2016 decreased by \$29,000 to \$24,000 as compared to \$53,000 for the same period a year ago. The decrease in interest expense for the three months ended September 30, 2016 resulted from lower average outstanding debt 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 September 30, 2016 increased by \$168,000 to \$124,000 as compared to a benefit of \$44,000 for the same period a year ago. The change in the provision for income taxes for the three months was caused primarily by the increase in income before taxes as compared to the same period a year ago as well as by the reversal of a liability during the three months ended September 30, 2015 that was no longer required relating to foreign source income. As a result, the Company's effective rate for income tax was 18% and (16)% for the three months ended September 30, 2016 and 2015, respectively.

Net income increased by \$253,000 to \$568,000 or \$0.03 per diluted share for the three months ended September 30, 2016 as compared to \$315,000 or \$0.02 per diluted share for the same period a year ago. The change in net income for the three months ended September 30, 2016 was primarily due to the items described above.

Liquidity and Capital Resources

During the three months ended September 30, 2016 the Company utilized a portion of its cash from operations (\$1,009,000 of \$1,919,000) to repay outstanding debt (\$875,000) and purchase property, plant and equipment (\$134,000). 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 September 30, 2016 decreased \$1,701,000 to \$17,311,000 as compared to \$19,012,000 at June 30, 2016. This decrease is primarily the result of the lower sales volume during the quarter ended September 30, 2016 as compared to the quarter ended June 30, 2016, which is typically the Company's highest.

Inventories at September 30, 2016 increased \$467,000 to \$25,804,000 as compared to \$25,337,000 at June 30, 2016. This increase is primarily the result of the Company's level-loading its production output throughout the year, whereas the Company's sales are typically highest in the fourth quarter.

Accounts payable and accrued expenses decreased \$280,000 to \$8,408,000 as of September 30, 2016 as compared to \$8,688,000 at June 30, 2016. This decrease was due primarily to higher levels of material purchases and selling

expenses during the quarter ended June 30, 2016 as compared to the quarter ended September 30, 2016.

As of September 30, 2016, long-term debt consisted of a revolving credit facility of \$11,000,000 (the "Revolving Credit Facility") which expires in June 2021 and a term loan for \$6,000,000 which expires in June 2019. Repayment of the Term Loan commenced on September 30, 2012 and is being repaid with 28 equal, quarterly payments of \$75,000 plus any additional payments made at the Company's discretion with the remaining balance of \$1,100,000 due on or before the expiration date. As of September 30, 2016, the Company had \$2,000,000 in outstanding borrowings and \$9,000,000 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 September 30, 2016 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 September 30, 2016, an aggregate principal amount of approximately \$3,925,000 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 \$39,000 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 or weakening in the U.S. dollar to the RD\$ would result in an annual increase or decrease in income from operations of approximately \$630,000.

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 September 30, 2016, 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 September 30, 2016.

During the three months ended September 30, 2016, 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, 2016. 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, 2016 during the three months ended September 30, 2016.

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

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.

November 7, 2016

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 |
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