

Edgar Filing: NAPCO SECURITY SYSTEMS INC - Form 10-Q

NAPCO SECURITY SYSTEMS INC  
Form 10-Q  
November 14, 2007

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

X QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND  
--- EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED: SEPTEMBER 30, 2007

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  
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NAPCO SECURITY SYSTEMS, 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 11701  
Amityville, New York  
-----  
(Address of principal executive offices) (Zip Code)

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

None  
-----  
(Former name, former address and former fiscal year if  
changed from last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes X No  
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PART I: FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

ASSETS -----	September 30, 2007 (unaudited) ----- (in thousands, except
Current Assets:	
Cash and cash equivalents	\$ 1,916
Accounts receivable, less reserve for doubtful accounts	22,106
Inventories, net	23,120
Prepaid expenses and other current assets	1,155
Deferred income taxes	1,079
	-----
Total Current Assets	49,376
Inventories - non-current, net	7,594
Property, plant and equipment, net	9,201
Goodwill, net	9,686
Other assets	264
	-----
Total Assets	\$76,121 =====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities:	
Accounts payable	\$ 5,383
Accrued expenses	1,726
Accrued salaries and wages	2,185
Accrued income taxes	332
	-----
Total Current Liabilities	9,626
Long-term debt	10,900
Accrued income taxes	2,605
Deferred income taxes	1,010
Minority interest in subsidiary	147
	-----
Total Liabilities	24,288 -----
Stockholders' Equity:	
Common stock, par value \$.01 per share; 40,000,000 shares authorized, 20,090,313 shares issued and 19,434,477 and 19,665,141 shares outstanding, respectively	201
Additional paid-in capital	13,205

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Retained earnings	42,188	-----
	55,594	-----
Less: Treasury Stock, at cost (655,836 and 425,172 shares, respectively)	(3,761)	-----
 Total stockholders' equity	 51,833	 -----
 Total Liabilities and Stockholders' Equity	 \$76,121	 =====

See accompanying notes to condensed consolidated financial statements.

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### NAPCO SECURITY SYSTEMS, INC AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

	Three Months Ended September 30,	
	2007	2006
	(in thousands, except share and per share data)	
Net sales	\$ 13,876	\$ 14,029
Cost of sales	8,747	8,470
	-----	-----
Gross Profit	5,129	5,559
Selling, general and administrative expenses	4,326	3,998
	-----	-----
Operating Income	803	1,561
	-----	-----
Interest expense, net	195	90
Other expenses, net	7	4
	-----	-----
Other expenses	202	94
	-----	-----
Income Before Minority Interest and Provision for Income Taxes	601	1,467
Minority interest in loss of subsidiary	38	13
	-----	-----
Income Before Provision for Income Taxes	639	1,480

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Provision for income taxes	265	528
	-----	-----
Net Income	\$ 374	\$ 952
	=====	=====
Earnings per share (Note 4):		
Basic	\$ 0.02	\$ 0.05
	=====	=====
Diluted	\$ 0.02	\$ 0.05
	=====	=====
Weighted average number of shares outstanding (Note 4):		
Basic	19,567,689	19,951,298
	=====	=====
Diluted	20,157,065	20,807,264
	=====	=====

See accompanying notes to condensed consolidated financial statements.

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

	Three Months End	
	September 30,	
	-----	-----
	2007	2006
	-----	-----
	(in thousands)	
Cash Flows from Operating Activities:		
Net income	\$ 374	\$ 952
Adjustments to reconcile net income to net cash and cash equivalents provided by (used in) operating activities:		
Depreciation and amortization	277	
Recovery of doubtful accounts	(40)	
Deferred income taxes	(254)	
Non-cash stock based compensation expense	59	
Changes in operating assets and liabilities:		
Accounts receivable	3,513	1,000
Inventories	(2,491)	(4,000)
Prepaid expenses and other current assets	16	(100)
Other assets	(71)	(100)
Accounts payable, accrued expenses, accrued salaries and wages, and accrued income taxes	500	(100)

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Net Cash Provided by (Used in) Operating Activities	1,883	(1,
Cash Flows Used in Investing Activities:		
Purchases of property, plant and equipment	(344)	(
Cash Flows from Financing Activities:		
Proceeds from exercise of employee stock options	-	
Cash paid for purchase of treasury stock	(1,371)	
Net Cash (Used in) Provided by Financing Activities	(1,371)	
Net increase (decrease) in Cash and Cash Equivalents	168	(1,
Cash and Cash Equivalents, Beginning of Period	1,748	2,
Cash and Cash Equivalents, End of Period	\$ 1,916	\$ 1,
Cash Paid During the Period for:		
-----		
Interest	\$ 186	\$
Income taxes	\$ -	\$
Non-cash Investing activities:		
-----		
Adjustment to Retained earnings relating to adoption of FIN 48 (see Note 8)	\$ 485	\$

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY SYSTEMS, INC AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1.) Summary of Significant Accounting Policies and Other Disclosures  
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The accompanying Condensed Consolidated Financial Statements are unaudited. In management's opinion, all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation have been made. The

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results of operations for the period ended September 30, 2007 are not necessarily indicative of results that may be expected for any other interim period or for the full year.

The unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended June 30, 2007. The accounting policies used in preparing these unaudited Condensed Consolidated Financial Statements are consistent with those described in the June 30, 2007 Consolidated Financial Statements. However, for interim financial statements, inventories are calculated using a gross profit percentage.

The consolidated financial statements include the accounts of Napco Security Systems, Inc. and all of its wholly-owned subsidiaries. The Company has also consolidated a 51%-owned joint venture. The 49% interest, held by a third party, is reflected as minority interest. All inter-company balances and transactions have been eliminated in consolidation.

The Company has made a number of estimates and assumptions relating to the assets and liabilities, the disclosure of contingent assets and liabilities and the reporting of revenues and expenses to prepare these financial statements in conformity with accounting principles generally accepted in the United States. Actual results could differ from those estimates.

### 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 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. To a lesser degree, sales in Europe are also adversely impacted in the Company's first fiscal quarter because of European vacation patterns, i.e., many distributors and installers are closed for the month of August. In addition, demand is affected by the housing and construction markets.

### Advertising and Promotional Costs

Advertising and promotional costs are included in "Selling, General and Administrative" expenses in the condensed consolidated statements of income and are expensed as incurred. Advertising expense for the three months ended September 30, 2007 and 2006 was \$522,000 and \$358,000, respectively.

### Research and Development Costs

Research and development costs incurred by the Company are charged to expense in the year incurred. Company-sponsored research and development costs of \$1,332,000 and \$1,293,000 were charged to expense for the three months ended September 30, 2007 and 2006, respectively, and are included in "Cost of Sales" in the condensed consolidated statements of income.

### Business Concentration and 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 balances that

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aggregated 46% and 38% of the Company's accounts receivable at September 30, 2007 and June 30, 2007, respectively. Sales to neither of these customers exceeded 10% of net sales in any of the past three fiscal years.

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In the ordinary course of business, the Company has established a reserve for doubtful accounts and customer deductions in the amount of \$325,000 and \$365,000 as of September 30, 2007 and June 30, 2007, 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 trends.

### Stock Options

During the three months ended September 30, 2007 the Company granted no stock options under its 2002 Employee Incentive Stock Option Plan or its 2000 Non-employee Incentive Stock Option Plan. No options were exercised under these plans during the three months ended September 30, 2007.

### Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board ("FASB") issued SFAS Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109". FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes". This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for financial statements issued for fiscal years beginning after December 15, 2006 and is to be applied to all open tax years as of the date of effectiveness. The Company has adopted the provisions of FIN 48 effective July 1, 2007. For the effects of this implementation see Note 8.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". SFAS No. 157 provides guidance for using fair value to measure assets and liabilities. In addition, this statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Where applicable, this statement simplifies and codifies related guidance within generally accepted accounting principles. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company's adoption of SFAS No. 157 is not expected to have a material effect on its consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB No. 108") to provide guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. Under SAB No. 108, companies should evaluate a misstatement based on its impact on the current year income statement, as well as the cumulative effect of correcting such misstatements that existed in prior years existing in the current year's ending balance sheet. The



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Company's adoption of SAB No. 108 did not have a material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities". SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Most of the provisions of this Statement apply only to entities that elect the fair value option. However, the amendment to SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", applies to all entities with available-for-sale and trading securities. Some requirements apply differently to entities that do not report net income. SFAS No. 159 will become effective for the Company in its fiscal year ending June 30, 2009. The Company's adoption of SFAS No. 159 is not expected to have a material effect on its consolidated financial statements.

The FASB ratified the consensuses reached in EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)" ("EITF 06-3"). The EITF reached a consensus that the scope of the Issue includes any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer, and may include, but is not limited to, sales, use, value-added, and some excise taxes. The presentation of taxes within the scope of this Issue on either a gross or a net basis is an accounting policy decision that should be disclosed. Furthermore, for taxes reported on a gross basis, a company should disclose the aggregate amount of those taxes in interim and annual financial

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statements for each period for which an income statement is presented if that amount is significant. The disclosures required under this consensus should be applied retrospectively to interim and annual financial statements for all periods presented, if those amounts are significant. The Company adopted EITF 06-3 on January 1, 2006. The adoption of EITF 06-3 did not have a significant impact on the Company's consolidated financial statements. The Company currently records its sales net of any value added or sales tax.

### 2.) Stock-based Compensation

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The Company has established two share incentive programs as discussed in more detail in the Consolidated Financial Statements and related notes contained in the Company's annual report on Form 10-K for the year ended June 30, 2007. Prior to fiscal 2006, the Company applied the intrinsic value method as outlined in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("APB No. 25") and related interpretations in accounting for stock options and share units granted under these programs. Under the intrinsic value method, no compensation expense was recognized if the exercise price of the Company's stock options equaled the market price of the underlying stock on the date of the grant. Stock-based compensation costs of \$59,000 and \$84,000 were recognized in three months ended September 30, 2007 and 2006, respectively. Unearned stock-based compensation cost was \$522,000 as of September 30, 2007.

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### 3.) Inventories

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For interim financial statements, inventories are calculated using a gross profit percentage. The Company regularly reviews parts and finished goods inventories on hand and, when necessary, records a provision for excess or obsolete inventories. As of September 30, 2007 and June 30, 2007, balances in these reserves amounted to \$1,200,000. 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, 2007	June 30, 2007
Component parts	\$ 16,475	\$ 15,139
Work-in-process	3,416	3,139
Finished product	10,823	9,945
	-----	-----
	\$ 30,714	\$ 28,223
	=====	=====

Classification of inventories, net of reserves:

Current	\$ 23,120	\$ 21,342
Non-current	7,594	6,881
	-----	-----
	\$ 30,714	\$ 28,223
	=====	=====

### 4.) Earnings Per Common Share

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The Company follows the provisions of SFAS No. 128, "Earnings Per Share". In accordance with SFAS No. 128, earnings per common share amounts ("Basic EPS") were computed by dividing earnings by the weighted average number of common shares outstanding for the period. Earnings per common share amounts, assuming dilution ("Diluted EPS"), were computed by reflecting the potential dilution from the exercise of stock options. SFAS No. 128 requires the presentation of both Basic EPS and Diluted EPS on the face of the condensed consolidated statements of income.

A reconciliation between the numerators and denominators of the Basic and Diluted EPS computations for earnings is as follows (in thousands except per share data):

Three months ended September

Net Income (numerator)	Shares (denominator)
-----	-----

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Basic EPS		
-----		
Net income, as reported	\$ 374	19,568
Effect of dilutive securities		
-----		
Employee Stock Options	\$ -	589
-----		
Diluted EPS		
-----		
Net income, as reported and assumed option exercises	\$ 374	20,157
	=====	=====

62,000 options to purchase shares of common stock in the three months ended September 30, 2007 were excluded in the computation of Diluted EPS because the exercise prices were in excess of the average market price for this period and their inclusion would be anti-dilutive.

	Three months ended September	
	-----	
	Net Income (numerator)	Shares (denominator)
	-----	-----
Basic EPS		
-----		
Net income, as reported	\$ 952	19,951
Effect of dilutive securities		
-----		
Employee Stock Options	\$ -	856
-----		
Diluted EPS		
-----		
Net income, as reported and assumed option exercises	\$ 952	20,807
	=====	=====

37,000 options to purchase shares of common stock in the three months ended September 30, 2006 were excluded in the computation of Diluted EPS because the exercise prices were in excess of the average market price for this period.

5.) Long Term Debt

-----

Long-term debt consists of a revolving credit and term loan facility with a balance of \$10,900,000 at September 30, 2007 and at June 30, 2007. In September 2007, the Company amended its secured revolving credit agreement with its primary bank. The Company's borrowing capacity under the amended agreement was increased to \$25,000,000 from \$18,000,000. The amended revolving credit agreement is secured by all the accounts receivable, inventory, the Company's headquarters in Amityville, New York and certain other assets of Napco Security Systems, Inc. and the common stock of three of the Company's subsidiaries. The revolving credit agreement bears interest at either the Prime Rate less 1/4% or an alternate rate based on LIBOR as described in the agreement. As of September 30, 2007 the interest rate on the outstanding portion of this facility was 6.7%. The September

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2007 amendment also extended the revolving credit agreement to September 2011. Any outstanding borrowings are to be repaid or refinanced on or before that time. The agreement contains various restrictions and covenants including, among others, restrictions on payment of dividends, restrictions on borrowings, restrictions on capital expenditures, the maintenance of minimum amounts of tangible net worth, and compliance with other certain financial ratios, as defined in the agreement. As of September 30, 2007 the Company was not in compliance with one of these covenants relating to Tangible Net Worth for which it subsequently received the appropriate waiver and covenant amendment from its primary bank.

### 6.) Geographical Data

-----

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

The Company observes the provisions of SFAS No. 131. The following represents selected consolidated geographical data for the three months ended September 30, 2007 and 2006 (in thousands):

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	Three Months ended September 30,	
	2007	2006
Sales to external customers(1):		
Domestic	\$ 11,573	\$ 11,435
Foreign	2,303	2,594
Total Net Sales	\$ 13,876	\$ 14,029
	=====	=====
	As of	
	September 30, 2007	June 30, 2007
Identifiable assets:		
United States	\$ 46,441	\$ 47,636
Dominican Republic (2)	22,532	21,246
Other foreign countries	7,148	7,903
Total Identifiable Assets	\$ 76,121	\$ 76,785
	=====	=====

(1) All of the Company's sales occur in the United States and are shipped primarily from the Company's facilities in the United States and United Kingdom. There were no sales into any one foreign country in excess of 10% of Net Sales. (2) Consists primarily of inventories (\$17,534,000) and fixed assets (\$5,017,000) located at the Company's principal manufacturing facility in the Dominican Republic.

### 7.) Commitments and Contingencies

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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.

### 8.) Income Taxes

-----

In March 2003, Napco Security Systems, Inc. timely filed its income tax return for the fiscal year ended June 30, 2002. This return included an election to treat one of the Company's foreign subsidiaries, Napco DR, as if it were a domestic corporation beginning July 1, 2001. This election was based on a then recently enacted Internal Revenue Code ("Code") provision. As a result of this election, Napco DR is treated, for Federal income tax purposes, as transferring all of its assets to a domestic corporation in connection with an exchange. Although this type of transfer usually results in the recognition of taxable income to the extent of any untaxed earnings and profits, the Code provision provides an exemption for applicable corporations. The Company qualifies as an applicable corporation pursuant to this Code section, and based on this Code exemption, the Company treated the transfer of approximately \$27,000,000 of Napco DR's untaxed earnings and profits as nontaxable.

The Internal Revenue Service has issued a Revenue Procedure which is inconsistent with the Code exemption described above. The Code is the actual law; a Revenue Procedure is the IRS's interpretation of the law. The Code has a higher level of authority than a Revenue Procedure. Management believes that it has appropriately relied on the guidance in the Code when filing its income tax return. If challenged, the Company believes that the potential liability would have ranged from \$0 to \$9,450,000. However, the Company also believes there were other mitigating factors that would limit the amount of the potential liability, and as a result, management accrued a liability of \$2,243,000 as of June 30, 2002. As a result of the lapse in the applicable statute of limitations, the Company reversed \$407,000 of this accrued liability during fiscal 2007, resulting in a long-term accrued income tax liability of \$1,836,000 as of June 30, 2007.

As a result of the implementation of FIN48 as of July 1, 2007, the Company increased its accrued income tax liability by \$715,000, from \$1,836,000 to \$2,551,000, to provide for additional reserves for uncertain income tax positions, relating to the fiscal years 2004 through 2007, the only periods subject to examination by the taxing authorities. The increase in the accrued income tax liability of \$715,000 was offset in part by a \$230,000 increase in a related deferred income tax asset, resulting in a net reduction to retained earnings of \$485,000 (representing the cumulative effect of adopting FIN 48).

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During the quarter ended September 30, 2007, the Company increased its reserve for uncertain income tax positions by \$54,000, excluding the related deferred tax benefit (representing interest on unrecognized income tax positions), resulting in a long-term accrued income tax liability of \$2,605,000.

The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense and accrued income taxes. As of September 30, 2007, the Company had accrued interest totaling \$467,000, excluding the related deferred tax asset.

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As of September 30, 2007, the Company had, approximately \$2,325,000 of unrecognized net tax benefits (including the related accrued interest and net of the related deferred income tax benefit of \$280,000) that, if recognized, would favorably affect the effective income tax rate in any future periods.

The total accrued liability related to the election described above as of September 30, 2007 (including related accrued interest) totaled \$2,354,000. The statute of limitations on the remainder of this accrued liability is scheduled to lapse in fiscal 2008, which would result in a net benefit to income tax expense of \$2,198,000 (\$2,354,000 less the related \$156,000 deferred income tax benefit).

### 9.) Treasury Stock

-----  
On March 16, 2007, the Company announced that its Board of Directors authorized the repurchase of up to one million (1,000,000) shares of its common stock. As of September 30, 2007, the Company has repurchased 655,836 shares at a weighted average price of \$5.73 per share. Subsequent to September 30, 2007, the Company has repurchased an additional 85,593 shares at a weighted average price of \$5.48 per share.

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

#### ----- of Operations -----

Napco Security Systems, Inc.

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 continue growing 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, adverse tax consequences of offshore operations, distribution problems, unforeseen environmental liabilities and the uncertain military, political and economic conditions in the world.

#### Overview

The Company is a diversified manufacturer of security products, encompassing intrusion and fire alarms, building access control systems and electronic

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locking devices. 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 17% and 18% of our revenues for the three months ended September 30, 2007 and 2006, 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 customer demand or utilization of our manufacturing capacity. As product demand rises and factory utilization increases, the fixed costs are spread over increased output, which should improve profit margins. Conversely, when sales decline our fixed costs are spread over reduced levels, thereby decreasing margins.

In February 2004 the Company entered into a joint venture with an unrelated company to sell security-related products, including those manufactured by the Company, in the Middle East. The Company owns 51% of the newly formed company, an LLC organized in New York, which has its main operations in the United Arab Emirates. Revenues generated by this joint venture were approximately 3% of our revenues for the three months ended September 30, 2007.

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The security products market is characterized by constant incremental innovation in product design and manufacturing technologies. Generally, the Company devotes 7-8% of revenues to research and development (R&D) on an annual basis. Products resulting from our R&D investments in the three months ended September 30, 2007 did not contribute materially to revenue during this period, but should benefit the Company over future periods. 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

The post-September 11 era has generally been characterized by increased demand for electronic security products and services. The Company believes the security equipment market is likely to continue to exhibit healthy growth, particularly in industrial sectors, due to ongoing concerns over the adequacy of security safeguards. The Company's business is also affected by the housing markets. Demand for the Company's intrusion products, which accounted for approximately 50% of Net sales in Fiscal 2007, has a direct correlation to demand in the housing market.

### 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 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. To a lesser degree, sales in Europe are also adversely impacted in the Company's first fiscal quarter because of European vacation patterns, i.e., many distributors and installers are closed for the month of August. In addition, demand is affected by the housing and construction markets.

### Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared

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in conformity with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses reported in those financial statements. These judgments can be subjective and complex, and consequently actual results could differ from those estimates. Our most critical accounting policies relate to revenue recognition; concentration of credit risk; inventory; goodwill; and income taxes.

### Revenue Recognition

Revenues from merchandise sales are recorded at the time the product is shipped or delivered to the customer pursuant to the terms of sale. We report our sales levels on a net sales basis, which is computed by deducting from gross sales the amount of actual sales returns and allowances and an amount established for anticipated sales returns and allowances.

Our accrual for sales returns and allowances is a subjective critical estimate that has a direct impact on reported net sales and income. This accrual is calculated based on a history of gross sales and actual sales returns and allowances, as well as management's estimate of anticipated sales returns and allowances. As a percentage of gross sales, sales returns, rebates and other allowances were 4% and 9% for the three months ended September 30, 2007 and 2006, respectively.

### 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 balances that aggregated 46% and 38% of the Company's accounts receivable at September 30, 2007 and June 30, 2007, respectively. Sales to neither of these customers exceeded 10% of net sales in any of the past three fiscal years.

In the ordinary course of business, we have established a reserve for doubtful accounts and customer deductions in the amount of \$325,000 and \$365,000 as of September 30, 2007 and June 30, 2007, 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 trends.

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### Inventories

For interim financial statements, inventories are calculated using a gross profit percentage. This valuation method is based, in part, on subjective estimates and approximations 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



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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.

### Goodwill

Effective July 1, 2001, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. These statements established accounting and reporting standards for acquired goodwill and other intangible assets. Specifically, the standards address how acquired intangible assets should be accounted for both at the time of acquisition and after they have been recognized in the financial statements. In accordance with SFAS No. 142, intangible assets, including purchased goodwill, must be evaluated for 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 an impairment, the Company measures the amount of impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. At the close of Fiscal 2007, the Company performed its annual impairment evaluation required by this standard and determined that its goodwill is not impaired.

### Income Taxes

In March 2003, Napco Security Systems, Inc. timely filed its income tax return for the fiscal year ended June 30, 2002. This return included an election to treat one of the Company's foreign subsidiaries, Napco DR, as if it were a domestic corporation beginning July 1, 2001. This election was based on a then recently enacted Internal Revenue Code ("Code") provision. As a result of this election, Napco DR is treated, for Federal income tax purposes, as transferring all of its assets to a domestic corporation in connection with an exchange. Although this type of transfer usually results in the recognition of taxable income to the extent of any untaxed earnings and profits, the Code provision provides an exemption for applicable corporations. The Company qualifies as an applicable corporation pursuant to this Code section, and based on this Code exemption, the Company treated the transfer of approximately \$27,000,000 of Napco DR's untaxed earnings and profits as nontaxable.

The Internal Revenue Service has issued a Revenue Procedure which is inconsistent with the Code exemption described above. The Code is the actual law; a Revenue Procedure is the IRS's interpretation of the law. The Code has a higher level of authority than a Revenue Procedure. Management believes that it has appropriately relied on the guidance in the Code when filing its income tax return. If challenged, the Company believes that the potential liability would have ranged from \$0 to \$9,450,000. However, the Company also believes there were other mitigating factors that would limit the amount of the potential liability, and as a result, management accrued a liability of \$2,243,000 as of June 30, 2002. As a result of the lapse in the applicable statute of limitations, the Company reversed \$407,000 of this accrued liability during fiscal 2007, resulting in a long-term accrued income tax liability of \$1,836,000 as of June 30, 2007.

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As a result of the implementation of FIN48 as of July 1, 2007, the Company increased its accrued income tax liability by \$715,000, from \$1,836,000 to \$2,551,000, to provide for additional reserves for uncertain income tax positions, relating to the fiscal years 2004 through 2007, the only periods subject to examination by the taxing authorities. The increase in the accrued income tax liability of \$715,000 was offset in part by a \$230,000 increase in a related deferred income tax asset, resulting in a net reduction to retained earnings of \$485,000 (representing the cumulative effect of adopting FIN 48).

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During the quarter ended September 30, 2007, the Company increased its reserve for uncertain income tax positions by \$54,000, excluding the related deferred tax benefit (representing interest on unrecognized income tax positions), resulting in a long-term accrued income tax liability of \$2,605,000.

The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense and accrued income taxes. As of September 30, 2007, the Company had accrued interest totaling \$467,000, excluding the related deferred tax asset.

As of September 30, 2007, the Company had, approximately \$2,325,000 of unrecognized net tax benefits (including the related accrued interest and net of the related deferred income tax benefit of \$280,000) that, if recognized, would favorably affect the effective income tax rate in any future periods.

The total accrued liability related to the election described above as of September 30, 2007 (including related accrued interest) totaled \$2,354,000. The statute of limitations on the remainder of this accrued liability is scheduled to lapse in fiscal 2008, which would result in a net benefit to income tax expense of \$2,198,000 (\$2,354,000 less the related \$156,000 deferred income tax benefit).

### Results of Operations

	----- Three months ended September 30, (in thousands) -----		
	2007	2006	% Increase/ (decrease)
	-----		
Net sales	\$ 13,876	\$ 14,029	(1.1)%
Gross profit	5,129	5,559	(7.7)%
Gross profit as a % of net sales	37.0%	39.6%	(2.6)%
Selling, general and administrative	4,326	3,998	8.2%
Selling, general and administrative as a percentage of net sales	31.2%	28.5%	2.7%
Operating income	803	1,561	(48.6)%
Interest expense	195	90	116.7%
Other expense	7	4	75.0%
Minority interest in net loss (income) of subsidiary, net	38	13	192.3%
Provision for income taxes	265	528	(49.8)%
Net income	374	952	(60.7)%
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Sales for the three months ended September 30, 2007 decreased by approximately

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1% to \$13,876,000 as compared to \$14,029,000 for the same period a year ago. The decrease in sales for the three months was due to lower sales in the Company's Access Control products as partially offset by increases in the Company's intrusion-related sales..

The Company's gross profit for the three months ended September 30, 2007 decreased by \$430,000 to \$5,129,000 or 37.0% of sales as compared to \$5,559,000 or 39.6% of sales for the same period a year ago. The decrease in gross profit was due primarily to lower production levels, and an associated decrease in overhead absorption rates, in the first three months of fiscal 2008 as compared to the same period in fiscal 2007 as well as a reduction in the first quarter of fiscal 2006 in the Company's inventory reserves of approximately \$150,000.

Selling, general and administrative expenses for the three months ended September 30, 2007 increased by \$328,000 to \$4,326,000, or 31.2% of sales, as compared to \$3,998,000, or 28.5% of sales a year ago. The increase in dollars and as a percentage of sales for the three months ended September 30, 2007 was due primarily to the timing of tradeshow expenses relating to a major tradeshow which occurred in September 2007. The same tradeshow occurred in October of 2006 in the prior fiscal year.

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Interest expense, net for the three months ended September 30, 2007 increased by \$105,000 to \$195,000 as compared to \$90,000 for the same period a year ago. This increase resulted primarily from the increase in the Company's average outstanding debt, the result of the Company's increase in inventory as discussed below.

The Company's provision for income taxes for the three months ended September 30, 2007 decreased by \$263,000 to \$265,000 as compared to \$528,000 for the same period a year ago. The tax provision for the three months ended September 30, 2007 is calculated using an estimated annual effective tax rate of 36%. The Company's effective rate for the three months ended September 30, 2007 was 41%, which included an additional provision of \$36,000 resulting from the Company's adoption of FIN48 as described in Note 8. The decrease in provision for income taxes for the three months resulted primarily from the decrease in Income before income tax.

Net income decreased by \$578,000 to \$374,000 or \$0.02 per diluted share for the three months ended September 30, 2007 as compared to \$952,000 or \$0.05 per diluted share for the same period a year ago. This decrease was primarily due to the aforementioned decreases in gross profit and increases in selling, general and administrative and interest expenses, net of the related decrease in provision for income taxes.

### Liquidity and Capital Resources

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During the three months ended September 30, 2007 the Company utilized all of its cash from operations to purchase property, plant and equipment (\$344,000) and treasury stock (\$1,371,000). One of the key factors in the use of operating cash was our investment in additional inventory (\$2,491,000) as discussed below. The Company's management believes that current working capital, cash flows from operations and its revolving credit agreement will be sufficient to fund the Company's operations through at least the next twelve months.

Accounts Receivable at September 30, 2007 decreased \$3,473,000 to \$22,106,000 as compared to \$25,579,000 at June 30, 2007. This decrease is primarily the result of the higher sales volume during the quarter ended June 30, 2007 as compared to

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the quarter ended September 30, 2007 as partially offset by extended terms granted to certain of the Company's customers during the quarter ended June 30, 2007. Certain of these terms extended beyond September 30, 2007.

Inventories at September 30, 2007 increased by \$2,491,000 to \$30,714,000 as compared to \$28,223,000 at June 30, 2007. This increase was primarily the result of the Company level-loading its production schedule in anticipation of its historical sales cycle where a larger portion of the Company's sales occur in the latter fiscal quarters as compared to the earlier quarters as well as to support a projection of higher sales in fiscal 2007.

In September 2007, the Company amended its secured revolving credit agreement with its primary bank. The Company's borrowing capacity under the amended agreement was increased to \$25,000,000 from \$18,000,000. As of September 30, 2007 there was approximately \$14,100,000 available under the secured revolving credit facility. The amended revolving credit agreement is secured by all the accounts receivable, inventory, the Company's headquarters in Amityville, New York and certain other assets of Napco Security Systems, Inc. and the common stock of three of the Company's subsidiaries. The revolving credit agreement bears interest at either the Prime Rate less 1/4% or an alternate rate based on LIBOR as described in the agreement. As of September 30, 2007 the interest rate on the outstanding portion of this facility was 6.7%. The September 2007 amendment also extended the revolving credit agreement to September 2011. Any outstanding borrowings are to be repaid or refinanced on or before that time. The agreement contains various restrictions and covenants including, among others, restrictions on payment of dividends, restrictions on borrowings, restrictions on capital expenditures, the maintenance of minimum amounts of tangible net worth, and compliance with other certain financial ratios, as defined in the agreement. As of September 30, 2007 the Company was not in compliance with one of these covenants relating to Tangible Net Worth for which it subsequently received the appropriate waiver and covenant amendment from its primary bank.

As of September 30, 2007 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

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The Company's principal financial instrument is long-term debt (consisting of a revolving credit facility) that provides for interest at a spread below the

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prime rate. The Company is affected by market risk exposure primarily through the effect of changes in interest rates on amounts payable by the Company under this credit facility. At September 30, 2007, an aggregate principal amount of approximately \$10,900,000 was outstanding under the Company's credit facility with a weighted average interest rate of approximately 6.7%. If principal amounts outstanding under the Company's credit facility remained at this year-end level for an entire year and the prime rate increased or decreased, respectively, by 1% the Company would pay or save, respectively, an additional \$109,000 in interest that year.

A significant number of foreign sales transactions by the Company are denominated in U.S. dollars. As such, the Company has shifted foreign currency

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exposure onto many of 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. In addition, the Company transacts certain sales in Europe in British Pounds Sterling, therefore exposing itself to a certain amount of foreign currency risk. Management believes that the amount of this exposure is immaterial. We are also exposed to foreign currency risk relative to expenses incurred in Dominican Pesos ("RD\$"), the local currency of the Company's production facility in the Dominican Republic. The result of a 10% strengthening in the U.S. dollar to our RD\$ expenses would result in an annual decrease in income from operations of approximately \$415,000.

### ITEM 4: Controls and Procedures

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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, 2007, 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 in alerting them in a timely manner to information relating to the Company required to be disclosed in this report except as follows:

Management's review over its internal controls at the conclusion of fiscal 2007 identified conditions which they deemed to be material weaknesses, (as defined by standards established by the SEC and the Public Company Accounting Oversight Board) with respect to certain of our inventory valuation estimation methods and the classification of inventory in accordance with Accounting Research Bulletin 43 ("ARB No. 43"). Management has informed its independent auditors and the Audit Committee that it has corrected its method of classifying its inventory so as to be in compliance with ARB No. 43, has initiated a review of the ways in which we can accumulate information to provide better substantiation of our overhead estimates, including implementation of an additional time-tracking system, and established an additional review of our obsolescence estimates. We will also conduct a review of our inventory turnover and utilize this review to support classification on the balance sheet to prevent reoccurrences of these material weaknesses and will continue to monitor the effectiveness of these actions and will make any other changes or take such additional actions as management determines to be appropriate. Management expects to complete these actions during fiscal 2008.

During the first quarter of fiscal 2008, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting except for the procedure described above which has corrected the weakness relating to inventory classification on the balance sheet.

## 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, 2007. There have been no material changes in the risk factors previously disclosed in the Company's Form 10-K for the year ended June 30, 2007 during the three months ended September 30, 2007.

## Item 2. Unregistered Sales of Equity Securities and Uses of Proceeds

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number Shares Purchased Part of Public Announced Program
July 1, 2007 - July 30, 2007	30,100	\$6.55	30,100
August 1, 2007 - August 31, 2007	121,800	\$5.90	121,800
September 1, 2007 - September 30, 2007	78,764	\$5.69	78,764
Total for the quarter ended September 30, 2007	230,664 =====	\$5.91	230,664 =====

On March 16, 2007, the Company announced that its Board of Directors authorized the repurchase of up to one million (1,000,000) shares of its common stock.

## Item 6. Exhibits

- 10.A Amended and Restated Loan and Security Agreement with HSBC Bank USA dated September 7, 2007
- 10.B Waiver and Amendment dated November 8, 2007 to Amended and Restated Loan and Security Agreement with HSBC Bank USA dated September 7, 2007
- 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

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 14, 2007

NAPCO SECURITY SYSTEMS, INC  
(Registrant)

By: /S/ RICHARD L. SOLOWAY

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Richard L. Soloway  
Chairman of the Board of Directors, President and Secretary  
(Chief Executive Officer)

By: /S/ KEVIN S. BUCHEL

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Kevin S. Buchel  
Senior Vice President of Operations and Finance and Treasurer  
(Principal Financial and Accounting Officer)