NAPCO SECURITY SYSTEMS INC
Form 10-Q
May 10, 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: MARCH 31, 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

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

Delaware	11-2277818
(State or other jurisdiction of incorporation of organization)	(IRS Employer Identification 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)

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 _____

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act):

Large Accelerated Filer _____ Accelerated Filer X _____ Non-Accelerated Filer _____

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

Yes _____ No X _____

Number of shares outstanding of each of the issuer's classes of common stock, as of: MAY 8, 2007

COMMON STOCK, $.01 PAR VALUE PER SHARE 19,815,313

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PART I: FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

ASSETS	March 31, 2007 (unaudited)
	(in thousands, ex
Current Assets:	
Cash and cash equivalents	$ 1,202
Accounts receivable, less allowance for doubtful accounts	22,343
Inventories, net	31,784
Prepaid expenses and other current assets	796
Deferred income taxes	1,735
Total current assets	57,860
Property, plant and equipment, net	8,967
Goodwill	9,686
Other assets	303
Total Assets	$ 76,816
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities:	
Accounts payable	$ 5,602
Accrued expenses	1,303
Accrued salaries and wages	2,092
Accrued income taxes	1,087
Total current liabilities	10,084
Long-term debt	9,200
Accrued income taxes	1,836
Deferred income taxes	1,911
Minority interest in subsidiary	147
Total liabilities	23,178
Stockholders' Equity:	
Common stock, par value $.01 per share; 40,000,000 shares authorized, 20,090,313 and 19,950,453 shares issued and 19,910,713 and 19,950,453 shares outstanding, respectively	201
Additional paid-in capital	13,071
Retained earnings	41,310
Less: Treasury Stock, at cost (179,600 shares)	(944)
Total stockholders' equity	53,638

Total Liabilities and Stockholders' Equity	$ 76,816

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 Mont March
		2007
		(in thousands, and per sh
Net sales		$ 15,566
Cost of sales		10,072
Gross Profit		5,494
Selling, general and administrative expenses		4,226
Operating Income		1,268
Interest expense, net		168
Other expenses, net		4
Other expenses		172
Income Before Minority Interest and Provision for Income Taxes		1,096
Minority interest in net loss (income) of subsidiary, net		41
Income Before Provision for Income Taxes		1,137
Provision for income taxes		5
Net Income		$ 1,132
Earnings per share (Note 1 and Note 4) *:	Basic	$ 0.06
	Diluted	$ 0.06
Weighted average number of shares outstanding (Note 1 and Note 4) *:	Basic	20,078,996
	Diluted	20,576,505

* The 3:2 stock split declared in May 2006 (see Note 1) has been retroactively reflected in all 2006 share and per share data.

See accompanying notes to condensed consolidated financial statements.

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

		Nine Months March
		2007
		(in thousands, and per sh
Net sales		$ 45,672
Cost of sales		28,794
Gross Profit		16,878
Selling, general and administrative expenses		12,205
Operating Income		4,673
Interest expense, net		377
Other expenses, net		13
Other expenses		390
Income Before Minority Interest and Provision for Income Taxes		4,283
Minority interest in net loss of subsidiary, net		95
Income Before Provision for Income Taxes		4,378
Provision for income taxes		1,150
Net Income		$ 3,228
Earnings per share (Note 1 and Note 4) *:	Basic	$ 0.16
	Diluted	$ 0.16
Weighted average number of shares outstanding (Note 1 and Note 4) *:	Basic	20,021,196
	Diluted	20,673,139

* The 3:2 stock split declared in May 2006 (see Note 1) has been retroactively reflected in all 2006 share and per share data.

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)

	Nine Months March
	2007
	(in thousa
Cash Flows from Operating Activities:	
Net income	$ 3,228
Adjustments to reconcile net income to net cash and cash equivalents (used in) operating activities:	
Depreciation and amortization	861
(Recovery of) provision for doubtful accounts	(80)
Deferred income taxes	(180)
Excess tax benefits from exercise of stock options	-
Non-cash stock based compensation expense	336
Changes in operating assets and liabilities:	
Accounts receivable	2,890
Inventories	(9,118)
Prepaid expenses and other current assets	(41)
Other assets	(152)
Accounts payable, accrued expenses, accrued salaries and wages, and accrued income taxes	(2,218)
Net Cash Used in Operating Activities	(4,474)
Cash Flows Used in Investing Activities:	
Purchases of property, plant and equipment	(786)
Cash Flows from Financing Activities:	
Proceeds from exercise of employee stock options	168
Cash paid for purchase of treasury stock	(944)
Proceeds from long-term debt	4,500
Excess tax benefits from exercise of stock options	-
Net Cash Provided by Financing Activities	3,724
Net (decrease) in Cash and Cash Equivalents	(1,536)
Cash and Cash Equivalents, Beginning of Period	2,738
Cash and Cash Equivalents, End of Period	$ 1,202
Cash Paid During the Period for:	
Interest	$ 325
Income taxes	$ 2,526

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

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 results of operations for the period ended March 31, 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 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, owned 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.

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, 2006. The accounting policies used in preparing these unaudited Condensed Consolidated Financial Statements are consistent with those described in the June 30, 2006 Consolidated Financial Statements. However, for interim financial statements, inventories are calculated using a gross profit percentage.

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.

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 March 31, 2007 and 2006 was $402,000 and $180,000, respectively. Advertising expense for the nine months ended March 31, 2007 and 2006 was $1,100,000 and $772,000, respectively. The significant increase in the current year is due to a major tradeshow occurring in March of 2007. The same tradeshow occurred in April 2006 last fiscal year.

Research and Development Costs

Research and development costs are included in Cost of Sales in the Condensed Consolidated Statements of Income and are expensed as incurred. Research and Development expense for the three months ended March 31, 2007 and 2006 was $1,325,000 and $1,286,000, respectively. Research and Development expense for the nine months ended March 31, 2007 and 2006 was $3,938,000 and $3,690,000, respectively.

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 differently, depending on the nature of the concentration, and vary in significance. The Company has two major customers with Sales and Accounts Receivable as follows (in thousands):

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	Sales for the three months ended March 31,				Sales for the nine months		
	2007		2006		2007		
	$	%	$	%	$	%	
Customer A	$ 1,327	8%	$ 1,402	8%	$ 3,733	8%	$
Customer B	1,384	9%	1,190	7%	3,904	9%	
	$ 2,711	17%	$ 2,592	15%	$ 7,637	17%	$

	Accounts Receivable as of:			
	March 31, 2007		June 30, 2006	
	$	%	$	%
Customer A	$ 5,251	24%	$ 5,225	21%
Customer B	3,817	17%	3,083	12%
	$ 9,068	41%	$ 8,308	33%

These customers sell primarily within North America. Although management believes that these customers are sound and creditworthy, a severe adverse impact on their business operations could have a corresponding material adverse effect on the Company's net sales, cash flows, and/or financial condition. In the ordinary course of business, the Company has established an allowance for doubtful accounts and customer deductions in the amount of $340,000 and $420,000 as of March 31, 2007 and June 30, 2006, respectively. The decrease in this allowance related primarily to the Company's recent history of lower bad debt write-offs. The allowance for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This allowance is based upon the evaluation of accounts receivable aging, specific exposures and historical trends.

Stock Options

During the three and nine months ended March 31, 2007 the Company granted 0 and 66,500 stock options, respectively, under its 2002 Employee Incentive Stock Option Plan. These grants have exercise prices between $6.02 and $6.62, a fair market value of $259,000 and vest over a four year period from the date of grant. No options were exercised under this plan during the three months ended March 31, 2007. 139,860 options were exercised under this plan with proceeds of $168,000 during the nine months ended March 31, 2007.

During the three and nine months ended March 31, 2007 the Company granted 30,000 options under its 2000 Non-employee Stock Option Plan. These grants have an exercise price of $5.03, a fair market value of $94,800 and vest over a four year period from the date of grant. No options were exercised under this plan during the three or nine months ended March 31, 2007.

The fair value of each option granted during the first nine months of fiscal 2007 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

Risk-free interest rates	4.7%
Expected lives	7.15 years
Expected volatility	59%
Expected dividend yields	0%

Stock Dividend

On May 10, 2006 the Company's Board of Directors approved a 3-for-2 stock split of its common stock, to be paid in the form of a 50% stock dividend to stockholders of record on May 24, 2006. The Company delivered the shares on June 7, 2006. Upon completion of the split, the total number of shares of common stock outstanding increased from approximately 13,300,000 to approximately 19,950,000.

All share and per share amounts (except par value) have been retroactively adjusted to reflect the stock split. There was no net effect on total stockholders' equity as a result of this transaction.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("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. The Company is currently evaluating the impact of the application of FIN 48.

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 condensed 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. SAB No. 108 will become effective for the Company in its fiscal year ending June 30, 2007. The Company's adoption of SAB No. 108 did not have a material impact on its condensed 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 condensed consolidated financial statements.

2.) Stock-based Compensation

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, 2006. 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 $107,000 and $197,000 were recognized in three months ended March 31, 2007 and 2006, respectively. Stock-based compensation costs of $336,000 and $312,000 were recognized in nine months ended March 31, 2007 and 2006, respectively.

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3.) Inventories

Inventories consist of (in thousands):	March 31, 2007	June 30, 2006
Component parts	$ 18,980	$ 13,533
Work-in-process	3,640	2,595

Finished products	9,164	6,538
	$ 31,784	$ 22,666

For interim financial statements, inventories are calculated using a gross profit percentage. 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 and requirements to support forecasted sales. As of March 31, 2007 and June 30, 2006, balances in these reserves amounted to $836,000 and $987,000, respectively. In addition, and as necessary, the Company may establish specific reserves for future known or anticipated events.

4.) Earnings Per Common Share

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) (Information reflects the stock splits as described in Note 1):

	Three months ended March 31, 2007		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
Basic EPS			
Net income, as reported	$ 1,132	20,079	$ 0.06
Effect of dilutive securities			
Employee Stock Options	$ -	498	$ -
Diluted EPS			
Net income, as reported and assumed option exercises	$ 1,132	20,577	$ 0.06

154,000 options to purchase shares of common stock in the three months ended March 31, 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 March 31, 2006		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
Basic EPS			

	Net Income (numerator)	Shares (denominator)	Per Share Amounts
Net income, as reported	$ 1,475	19,868	$ 0.07
Effect of dilutive securities			
Employee Stock Options	$ -	843	$ -
Diluted EPS			
Net income, as reported and assumed option exercises	$ 1,475	20,711	$ 0.07

25,000 options to purchase shares of common stock in the three months ended March 31, 2006 were excluded in the computation of Diluted EPS because the exercise prices were in excess of the average market price for this period.

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	Nine months ended March 31, 2007		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
Basic EPS			
Net income, as reported	$ 3,228	20,021	$ 0.16
Effect of dilutive securities			
Employee Stock Options	$ -	652	$ -
Diluted EPS			
Net income, as reported and assumed option exercises	$ 3,228	20,673	$ 0.16

82,000 options to purchase shares of common stock in the nine months ended March 31, 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.

	Nine months ended March 31, 2006		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
Basic EPS			
Net income attributable, as reported	$ 3,773	19,730	$ 0.19
Effect of dilutive securities			
Employee Stock Options	$ -	851	$ (0.01)
Diluted EPS			
Net income, as reported and assumed option exercises	$ 3,773	20,581	$ 0.18

25,000 options to purchase shares of common stock in the nine months ended March 31, 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

The Company's primary source of financing is an $18,000,000 revolving credit agreement, secured by all the accounts receivable, inventory, the Company's headquarters in Amityville, New York, common stock of three of the Company's subsidiaries and certain other assets of Napco Security Systems, Inc. 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. 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. The agreement currently has an expiration date of September 2008 and any outstanding borrowings are to be repaid or refinanced on or before that time. The Company has received a written commitment from its bank to amend the agreement to provide for an increase to $25,000,000 and extension of the expiration date to September 2011. The Company anticipates executing this amendment prior to June 30, 2007.

6.) Geographical Data

The Company's domestic and foreign sales and identifiable assets for the periods presented are summarized in the following tabulation (in thousands):

	Three Months ended March 31,		Nine Months ended March 3	
	2007	2006	2007	2006
Sales to external customers(1):				
Domestic	$ 13,407	$ 14,375	$ 39,215	$ 41,
Foreign	2,159	2,710	6,457	7,
Total Net Sales	$ 15,566	$ 17,085	$ 45,672	$ 48,

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	As of	
	March 31, 2007	June 30, 2006
Identifiable assets:		
United States	$ 45,826	$ 47,175
Dominican Republic (2)	24,797	18,924
Other foreign countries	6,193	5,623
Total Identifiable Assets	$ 76,816	$ 71,722

(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 and fixed assets located at the Company's principal manufacturing facility in the Dominican Republic.

7.) Commitments and Contingencies

In December 2004, the Company became a defendant in a product related lawsuit, in which the plaintiff seeks damages of approximately $1,500,000. This action is being defended by the Company's insurance company on behalf of the Company. Management believes that the action is without merit and plans to have this action vigorously defended.

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 originally determined that the potential liability would range from $0 to $9,450,000. However, the Company also believes there are 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 of March 31, 2007, $400,000 of this accrued liability was no longer required. The Company reduced this accrued liability accordingly in March 2007 which reduced the Company's effective tax rate from approximately 36% to 0% and 26% for the three and nine months ended March 31, 2007. The Company expects to eliminate the balance in fiscal 2008. The Company's tax provision utilizes estimates made by management and as such, is subject to change as described in Note 1 of the Consolidated financial statements included in the Company's Form 10-K for the year ended June 30, 2006.

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 March 31, 2007, the Company has repurchased 179,600 shares at a weighted average price of $5.22 per share. Subsequent to March

31, 2007, the Company has repurchased an additional 95,400 shares at a weighted average price of $5.74 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 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 16% of our revenues for fiscal year 2006 and 14% for the first nine months of fiscal 2007.

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 production rises and factory utilization increases, the fixed costs are spread over increased output, which has a positive impact on profit margins. Conversely, when production and factory utilization decline our fixed costs are spread over reduced levels, thereby having a negative impact on profit 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 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 2% of our

revenues for fiscal 2006 and 2% for the first nine months of fiscal 2007.

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

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.

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.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared 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; inventories; 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 purchase. We report our sales levels on a net sales basis, which is computed by deducting from gross sales the amount of actual returns received and an amount established for anticipated returns and allowances.

Our sales return accrual 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, as well as management's estimate of anticipated returns and allowances.

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 differently, depending on the nature of the concentration, and vary in significance. The Company has two major customers with Sales and Accounts Receivable as follows (in thousands):

	Sales for the three months ended March 31,				Sales for the nine months		
	2007		2006		2007		
	$	%	$	%	$	%	
Customer A	$ 1,327	8%	$ 1,402	8%	$ 3,733	8%	$
Customer B	1,384	9%	1,190	7%	3,904	9%	
	$ 2,711	17%	$ 2,592	15%	$ 7,637	17%	$

	Accounts Receivable as of:			
	March 31, 2007		June 30, 2006	
	$	%	$	%
Customer A	$ 5,251	24%	$ 5,225	21%
Customer B	3,817	17%	3,083	12%
	$ 9,068	41%	$ 8,308	33%

These customers sell primarily within North America. Although management believes that these customers are sound and creditworthy, a severe adverse impact on their business operations could have a corresponding material adverse effect on the Company's net sales, cash flows, and/or financial condition. In the ordinary course of business, the Company has established an allowance for doubtful accounts and customer deductions in the amount of $340,000 and $420,000 as of March 31, 2007 and June 30, 2006, respectively. The decrease in this allowance related primarily to the Company's recent history of lower bad debt write-offs. The allowance for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This allowance is based upon the evaluation of accounts receivable aging, specific exposures and historical trends.

Inventories

We state our inventory at the lower of cost or fair market value, with cost being determined on the first-in, first-out (FIFO) method. We believe FIFO most closely matches the flow of our products from manufacture through sale. The reported net value of our inventory includes finished saleable products, work-in-process and raw materials that will be sold or used in future periods. Inventory cost includes raw materials, direct labor and overhead.

We also record 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 and requirements to support forecasted sales. In addition, and as necessary, we may establish specific reserves for future known or anticipated events. For interim financial statements, inventories are calculated using a gross profit percentage.

Goodwill and Other Intangible Assets

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. The Company has performed its annual impairment evaluation required by this standard and determined that its goodwill is not impaired.

Income taxes

Deferred income taxes are recognized for the expected future tax consequences of temporary differences between the amounts reflected for financial reporting and tax purposes. Net deferred tax assets are adjusted by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax assets will not be realized. If the Company determines that a deferred tax asset will not be realizable or that a previously reserved deferred tax asset will become realizable, an adjustment to the deferred tax asset will result in a reduction of, or increase to, earnings at that time. The provision for income taxes represents U.S. Federal, state and foreign taxes. Through June 30, 2001, the Company's subsidiary in the Dominican Republic, Napco/Alarm Lock Group International, S.A. ("Napco DR"), was not subject to tax in the United States, as a result, no taxes were provided. Effective July 1, 2001, the Company made a domestication election for Napco DR. Accordingly, its income is subject to taxation in the United States on a going forward basis.

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 originally determined that the potential liability would range from $0 to $9,450,000. However, the Company also believes there are 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 of March 31, 2007, $400,000 of this accrued liability was no longer required. The Company reduced this accrued liability accordingly in March 2007 which reduced the Company's effective tax rate from approximately 36% to 0% and 26% for the three and nine months ended March 31, 2007, respectively. The Company expects to eliminate the balance in fiscal 2008. The Company's tax provision utilizes estimates made by management and as such, is subject to change as described in Note 1 of the Consolidated financial statements included in the Company's Form 10-K for the year ended June 30, 2006.

Results of Operations

	Three months ended March 31, (in thousands)			Nine months
	2007	2006	% Increase/ (decrease)	2007
Net sales	$ 15,566	$ 17,085	(8.9)%	$ 45,67
Gross profit	5,494	6,356	(13.6)%	16,87
Gross profit as a % of net sales	35.3%	37.2%	(1.9)%	37.
Selling, general and administrative	4,226	4,032	4.8%	12,20
Selling, general and administrative as a percentage of net sales	27.2%	23.6%	3.6%	26.
Operating income	1,268	2,324	(45.5)%	4,67
Interest expense	168	68	147.1%	37
Other expense	4	4	- %	1
Minority interest in net loss (income) of subsidiary, net	41	(2)	2,150.0%	9
Provision for income taxes	5	775	(99.4)%	1,15
Net income	1,132	1,475	(23.3)%	3,22

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Sales for the three months ended March 31, 2007 decreased by approximately 9% to $15,566,000 as compared to $17,085,000 for the same period a year ago. Sales for the nine months ended March 31, 2007 decreased by approximately 6% to $45,672,000 as compared to $48,488,000 for the same period a year ago. The decrease in sales for the three and nine months was due to lower sales in the Company's European market as disclosed last quarter and sales of the Company's burglar alarm products in the United States which management believes was impacted by the slowdown in the U.S. housing market. These factors were partially offset by higher sales of the Company's access control and door locking devices which also have higher average profit margins.

The Company's gross profit for the three months ended March 31, 2007 decreased by $862,000 to $5,494,000 or 35.3% of sales as compared to $6,356,000 or 37.2% of sales for the same period a year ago. The Company's gross profit for the nine months ended March 31, 2007 decreased by $652,000 to $16,878,000 or 37.0% of sales as compared to $17,530,000 or 36.2% of sales for the same period a year

ago. The decrease in gross profit for the three months was due primarily to the lower sales for the period as partially offset by a positive raw material pricing variance. The increase in gross profit for the nine months was due primarily to the same factors affecting the three months as well as a reduction in the first fiscal quarter in the Company's inventory reserves of approximately $150,000 and increased overhead absorption resulting from the increased production rate described below.

Selling, general and administrative expenses for the three months ended March 31, 2007 increased by $194,000 to $4,226,000, or 27.2% of sales, as compared to $4,032,000, or 23.6% of sales a year ago. Selling, general and administrative expenses for the nine months ended March 31, 2007 increased by $515,000 to $12,205,000, or 26.7% of sales, as compared to $11,690,000, or 24.1% of sales a year ago. The increase in dollars and as a percentage of sales for the three months ended March 31, 2007 was due primarily to the timing of tradeshow expenses relating to a major tradeshow which occurred in March 2007. The same tradeshow occurred in April of 2006 in the prior year. The increase for the nine months ended March 31, 2007 was due to the timing of these tradeshow expenses as well as advertising of the Company's access control products, commission expense related to increases in sales of the Company's door-locking products and additional expenses relating to the Company's initial audit of its internal controls required by the Sarbanes-Oxley Act of 2002. As fiscal 2006 was the initial period requiring an audit by the Company's Independent Registered Public Accounting Firm and that the opinion expressed by them for that period was that our assessment that we maintained effective internal controls over financial reporting was fairly stated, Management believes that these audit expenses will be reduced for fiscal 2007 as much of the documentation performed for the initial assessment and audit will be utilized in subsequent periods. These increases were partially offset by a decrease in bad debt expense resulting from the Company's recent history of lower bad debt write-offs.

Interest expense, net for the three months ended March 31, 2007 increased by $100,000 to $168,000 as compared to $68,000 for the same period a year ago. Interest expense, net for the nine months ended March 31, 2007 increased by $211,000 to $377,000 as compared to $166,000 for the same period a year ago. These increases resulted primarily from the increase in the Company's average outstanding debt, the result of the Company's increase in inventory as discussed below, as well as in interest rates as compared to those from the same period a year ago.

The Company's provision for income taxes for the three months ended March 31, 2006 decreased by $770,000 to $5,000 as compared to $775,000 for the same period a year ago. The Company's provision for income taxes for the nine months ended March 31, 2007 decreased by $854,000 to $1,150,000 as compared to $2,004,000 for the same period a year ago. The tax provision for the three and nine months ended March 31, 2007 is calculated using an estimated annual effective tax rate of 36% and 35%, respectively. The decrease in provision for income taxes for the three and nine months resulted from the decrease in Income before income tax. In addition, the reduction of an accrued tax liability, as discussed above, decreased the provision for the three and nine months by approximately $400,000.

Net income decreased by $343,000 to $1,132,000 or $0.06 per diluted share for the three months ended March 31, 2007 as compared to $1,475,000 or $0.07 per diluted share for the same period a year ago. Net income decreased by $545,000 to $3,228,000 or $0.16 per diluted share for the nine months ended March 31, 2007 as compared to $3,773,000 or $0.18 per diluted share for the same period a year ago. These decreases were primarily due to the aforementioned decreases in net sales and gross profit and increases in selling, general and administrative expenses, net of the related decrease in provision for income taxes.

Liquidity and Capital Resources

During the nine months ended March 31, 2007 the Company utilized $1,704,000 of cash and $4,500,000 in additional borrowings to fund the cash used in operations ($4,474,000), purchase property, plant and equipment ($786,000) and treasury stock ($944,000). One of the key factors in the use of operating cash was our investment in additional inventory ($9,118,000) 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 March 31, 2007 decreased $2,810,000 to $22,343,000 as compared to $25,153,000 at June 30, 2006. This decrease is primarily the result of the higher sales volume during the quarter ended June 30, 2006 as compared to the quarter ended March 31, 2007 as partially offset by extended terms granted to certain of the Company's customers during the quarter ended June 30, 2006. Certain of these terms extended beyond March 31, 2007.

Inventories at March 31, 2007 increased by $9,118,000 to $31,784,000 as compared to $22,666,000 at June 30, 2006. 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 producing additional inventory to support the introduction of the Company's new Freedom 64 code-less intrusion alarm system and several other key new products as well as to support a projection of higher sales in fiscal 2007. Because these levels were not realized, during the third quarter of fiscal 2007 the Company initiated several steps in order to reduce inventory levels, including reduced its purchasing levels, manufacturing labor and production output, and anticipates realizing their full effectiveness in the coming quarters.

As of March 31, 2007, the Company's credit facility consisted of an $18,000,000 secured revolving credit agreement. As of March 31, 2007 there was approximately $8,800,000 available under the secured revolving credit facility. This credit facility currently expires in September 2008. In April 2007, the Company obtained a written commitment from it's bank to amend the agreement to provide for an increase to $25,000,000 and extension of the expiration date to September 2011. The Company anticipates executing this amendment prior to June 30, 2007.

As of March 31, 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

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 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 March 31, 2007, an aggregate principal amount of approximately $9,200,000 was outstanding under the Company's credit facility. If principal amounts outstanding under the Company's credit facility remained at this quarter-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 $92,000 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 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 $450,000.

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 March 31, 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.

During the third quarter of fiscal 2007, 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.

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, 2006. 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, 2006 during the three months ended March 31, 2007.

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

Total Number of

Period	Total Number of shares Purchased	Average Price paid per Share	Shares Purchased as Part of Publically Announced Plans or Programs	Maxim Share be Pu Plans
January 1, 2007 - January 31, 2007	-	n/a	-	
February 1, 2007 - February 28, 2007	-	n/a	-	
March 1, 2007 - March 31, 2007	179,600	$ 5.22	179,600	8

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

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.

May 10, 2007

NAPCO SECURITY SYSTEMS, 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)