

NAPCO Security Technologies, Inc.

Total Security Solution for Wireless Locking, Access Control & Alarms

Security & Fire
Systems plus Cell/IP
Alarm Reporting



NAPCO

Complete Platform:
Access, Wireless
Locking & Security
Management



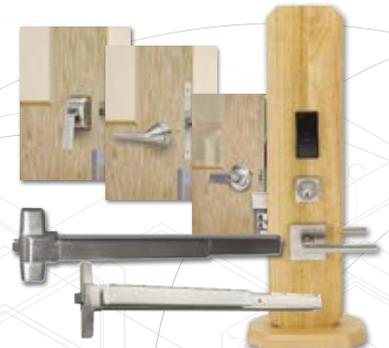
Continental
Access

Wireless Locking &
Standalone Access
& Egress



ALARM
LOCK

Architectural Door
Hardware, Locks,
Lifesafety & Exit Trim



MARKS
USA

NAPCO Security Technologies, Inc. provides commercial and residential security through a professional dealer network of more than 10,000 security dealers, integrators, locksmiths and contractors worldwide. Its innovative, synergistic products and technologies, provide solutions in three main categories: alarms and connectivity, locking and access control and surveillance.

One of NAPCO's strong growth drivers is recurring revenue services from its cellular communicator - and connected home/business-brands. Among the fastest growing brands in its class, NAPCO StarLink® Alarm Communicators report alarm signals, now on the LTE® network, universally from any brand of security system, in lieu of telephone landlines and older cell networks, both rapidly disappearing. StarLink® is a proven go-to solution, ideal for all installed and new alarm systems, available for residential, as well as commercial fire alarm reporting. It checks all the boxes, as it is easy to install, economical and dependably uses today's leading cyber-protected networks, protecting security consumers and dealers' account bases and valuation.

Answering the needs of cellular-centric home- & business-owners, StarLink

Connect® is a cell communicator/ automation hub, used to update any of the millions of existing alarm systems out there (any brand). It provides iBridge® Connected Services, accessible from any smart phone/tablet via a new iBridge App, integrating security, video and smart automation. Complementary products, include the new matching iBridge Wall-Mount IoT Touchscreen and new iBridge Video Doorbell. All feature integrated Messenger™ SMS/MMS text and video alerts. iBridge offers dealers value-added services to add to any subscriber's system, old and new accounts, providing incremental Recurring Monthly Revenue for both the installer and the Company.

A long-time trusted source in some of the largest school districts and leading colleges and universities across the country, NAPCO and its divisions, Alarm Lock®, Continental Access®, and Marks USA®, continue to evolve and expand their LocDown™ security solutions, to fit any classroom, campus and budget. From enterprise access control systems with integrated access control, locks, alarms, video and visitor-/ threat-management to award-winning wireless networked access locks with built-in ID readers and keyfob-control; or LocDown™ mechanical locks that lock

from inside the classroom, the Company makes the scalable solutions needed to safeguard schools, students and staffers. In this same vertical, NAPCO Commercial™ security systems have gained considerable traction providing intrusion and lifesafety protection in new addressable and wireless systems and upgrade applications.

Based on the continued popularity and strengths of Alarm Lock's® Trilogy Networx® Access Lock Platform, teamed with Marks'® wide array of architectural hardware, the Company created the new décor-friendly ArchiTech™ Series Designer Wireless Access Control line, designed with the proven functionality for traditional corporate, healthcare and educational campuses, plus new customizable aesthetics to satisfy even the most discriminating multi-dwelling residential buildings. These locks also offer a smartphone app paired with Bluetooth LE technology, for ultimate keyless user convenience and compromise-free security. Additionally, ArchiTech™ Locks are seamlessly integrated with several top enterprise class platforms, including Continental's® flagship CA4K® system, providing interoperable global control, real-time access, video and visitor management and a host of robust server-based advantages.

(NASDAQ:NSSC)

CEO Letter to Shareholders

Dear Fellow Shareholders,

Fiscal 2019 was a successful and pivotal year for NAPCO, as the Company has now achieved 20 consecutive quarters of Year-Over-Year record sales, surpassed \$100 million in annual revenues, and continues to realize dramatic growth in recurring monthly revenue (RMR).

I am pleased to announce record revenues of \$102.9 million in Fiscal Year (FY) 2019, a 12% increase over FY 2018. Operating income increased 60% in FY 2019 to \$13.5 million. Net income increased 60% in FY 2019 to a record \$12.2 million, or \$0.66 per diluted share. Adjusted EBITDA* also rose 51% in FY 2019 to \$15.0 million, or \$0.81 per diluted share.

Growth and profitability are also reflected in our balance sheet. At June 30, 2019, the Company had \$8.0 million in cash and cash equivalents as compared to \$5.3 million as of June 30, 2018. Working capital (current assets less current liabilities) rose to \$51.1 million at June 30, 2019, as compared to \$44.3 million at June 30, 2018. Our current ratio (current assets divided by current liabilities) was 4.6:1 at June 30, 2019 versus 5.7:1 at June 30, 2018. We also have zero net debt.

Being 100% focused on selling B2B, with a loyal following of thousands of professional security dealers, locksmiths, and systems integrators, we are able to make substantial progress in several key areas: establishing a more robust and diversified business model that

augments equipment sales with high margin recurring monthly revenues (RMR) earned by selling software as a service (SAAS); our business is 80% commercial, which lessens the impact of the more volatile consumer market; we're a leading developer of innovative and cost effective security solutions for the school and university market; and we continue to control overhead costs by carefully managing R&D and SGA expenses, with a dedicated low-cost manufacturing facility in the Dominican Republic that has avoided the costly tariffs associated with the US-China trade war.

Recurring monthly revenues are expanding rapidly

During FY 2019, recurring monthly revenue (RMR) increased 45%, a \$20.4 million annual run rate based on our June 2019 recurring revenue. RMR income carries gross margins of approximately 80%.

NAPCO is well positioned within market niches that offer promising, aggressive growth opportunities for RMR. For example, during Q4 of FY 2019 we launched our new AT&T LTE StarLink® line of cellular phone-based universal fire, intrusion alarm and IoT communicators. Old-fashioned copper wire is rapidly disappearing, creating the ideal opportunity for StarLink cellphone-based communicators that work on both the Verizon LTE and AT&T LTE networks, enabling NAPCO and its dealers to access the largest LTE service coverage area in the industry. Expanding the StarLink product line allows us to offer the security industry's most extensive and complete line of



Richard L. Soloway

Chairman, President, and CEO

alarm communication solutions, providing the ideal platform from which to capitalize on the fast-growing Wireless Cellular Alarm Communicator Category.

The award-winning StarLink Connect® solution, our IoT communicator, exhibited solid sales growth in FY 2019. StarLink Connect enables dealers to generate incremental RMR by upgrading the estimated 16 million legacy regular alarm systems to our iBridge® connected home/business solution, which allows end-user customers to use an app to remotely operate security systems, lighting, locks, thermostats, and video cameras, from any smart device.

All software as a service (SAAS) offerings are supported by our cloud-based state-of-the-art network operating center (NOC) that provides key communications to a vast number of independent central station monitoring service

*See table on inside back cover (page 51)

providers. A recent Capex investment allows us to expand NOC capacity to handle \$50 million in annual RMR income, with additional capacity to support future expansion of up to \$200 million per year in RMR revenue. Our long-term plan is to eventually generate RMR income with virtually every NAPCO product or service, including products in the fast-growing locking and access control segments.

Our business is 80% commercial

We have successfully transitioned from a core business focused on manufacturing consumer-oriented security devices to a far more diversified enterprise that realizes most of its revenue from the commercial business sector, which is far more stable and predictable. For example, whereas consumer Do-It-Yourself security solutions are an elective purchase decision, commercial security and fire prevention systems are required by state and local fire and safety codes and by insurers.

This past year, we launched a breakthrough commercial product called FireLink®, an all-in-one, 8-32 zone fire alarm control panel with a built-in cellular LTE, StarLink-powered alarm communicator that generates RMR revenue. FireLink comes pre-configured with an integrated, pre-activated cellular communicator, providing an easy-to-install solution that replaces aging landline-connected fire panels.

Our commercial security solutions also include fully integrated wireless access control solutions

that combine our Continental Division's enterprise-class access control systems with our Alarm Lock Division's ArchiTech™ and Network Series wireless access control locks.

NAPCO has the unique ability to integrate intelligent, cost-effective access control and locking devices into large and demanding end-user applications. We provide comprehensive end-to-end solutions, enabling us to quickly expand the number of access control points to protect virtually any building or facility.

Protecting schools, universities, and houses of worship

Active shooter incidents are on the rise at schools and universities, pressuring state and federal agencies to respond with over \$1 billion in additional funding for upgraded security systems.

NAPCO is ideally positioned within the education marketplace by offering comprehensive and fully integrated solutions that are flexible enough to address any budget. These products also protect houses of worship, malls, and other public gathering places, along with corporate, government, law enforcement, and military facilities. We offer a complete line of education-focused security solutions, including wireless locking and access control solutions that are marketed by our Alarm Lock, Marks, and Continental Access Control divisions, along with NAPCO's high-technology alarm and communication systems. Notable installations include the

San Diego Unified School District, Stanford, Pepperdine, and other leading universities. In addition, we are continuing to train record numbers of security dealers, systems integrators, and school personnel on how to use our proprietary School Access-control Vulnerability Index ("SAVI") and Audit System. The SAVI Index quantitatively measures a school's total security level, highlights deficiencies in the preparedness level, and creates an action plan to address any identified weaknesses.

Controlling R&D and SGA expenses

I'm also pleased to report that R&D spending as well as selling, general and administrative (SGA) expenses are rising at a slower pace than overall sales growth. R&D spending increased 9% in FY 2019 to \$7.2 million or 7% of overall sales, compared to \$6.6 million or 7.2% of sales last year. Selling, general and administrative expenses increased 1% to \$23.2 million, or 22.6% of sales, as compared to \$23.0 million, or 25.0% of sales for last year. Inventory levels remain slightly elevated in anticipation of several exciting new product launches.

All product design and certain manufacturing occurs at our Amityville facility, with most products being produced at our state-of-the-art ISO-9001:2015 certified low-cost manufacturing facility in the Dominican Republic. This facility offers numerous advantages, including less risk of intellectual property theft, no language barrier, and finished goods can be delivered in 6 days

instead of 3-4 weeks like most competing products that are made in China. The value of this dedicated DR facility is being further magnified during the US-China trade war, as we are avoiding tariffs and reducing our shipping costs.

Looking to the future

Offering over 5,000 innovative products and services, NAPCO remains the preferred choice of thousands of security dealers, locksmiths, and systems integrators. We develop industry leading solutions that encompass high-tech electronic intrusion security, Internet of Things (IoT) connected home, video and fire systems, as well as enterprise-class access control and door locking products. NAPCO products are preferred because they are fully networkable and interoperable, seamlessly integrating NAPCO's entire family of products as well as to products made by others.

Our product development pipeline is robust, including the highly anticipated launch of iSecure®, which won the Most Valuable Product (MVP) in the Home

Controls category at the ISC West trade show this past April. iSecure is a price competitive security monitoring solution sold by our dealers for homes and small businesses. iSecure features more advanced functionality than any competing DIY product, such as quick one-hour installation by professional installers.

In FY 2020, we also plan to launch an expansion of Marks anti-ligature locks. This product line expansion will result in unprecedented cylindrical, mortise styles, models and functions that meet and exceed rigorous Americans with Disabilities Act (ADA) and BHMA quality standards.

The senior management team at NAPCO owns 38% of all outstanding stock, so our interests are fully aligned with other investors who are seeking long-term growth, profitability, and return on equity. We also review all expenditures to invest resources wisely while continually looking to develop intelligent product solutions that offer highly profitable growth potential, now and in the future. Once again, I must thank our

hard-working employees, the many thousands of security dealers, locksmiths and systems integrators who loyally support us, and our investors, as it takes a combined effort to provide us with the talent and resources to grow and prosper within our industry.

Gratified by the progress we made this past year, we're confident that current and planned investments in product engineering and marketing will lead to unique and innovative products that drive high margin RMR sales growth. This helps make our revenue base more diversified and increasingly resilient to economic turbulence.

We will continue do everything we can to maintain this momentum.

Sincerely,



Richard L. Soloway
Chairman, President and CEO

* Non-GAAP Information. Certain non-GAAP measures are included in this document, including EBITDA, non-GAAP operating income and Adjusted EBITDA. We define EBITDA as GAAP net income plus income tax expense (benefit), net interest expense and depreciation and amortization expense. Non-GAAP operating income does not include impairment of goodwill, amortization of intangibles, restructuring charges, stock-based compensation expense and other infrequent or unusual charges. These non-GAAP measures are provided to enhance the user's overall understanding of our financial performance. By excluding these charges our non-GAAP results provide information to management and investors that is useful in assessing NAPCO's core operating performance and in comparing our results of operations on a consistent basis from period to period. The presentation of this information is not meant to be a substitute for the corresponding financial measures prepared in accordance with generally accepted accounting principles. Investors are encouraged to review the reconciliation of GAAP to non-GAAP financial measures included on page 51 of this document.

This letter contains statements relating to future results of the Company (including certain projections and business trends) that are "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those projected as a result of certain risks and uncertainties, including but not limited to, changes in political and economic conditions, demand for and market acceptance of new and existing products, as well as other risks and uncertainties detailed from time to time in the filings of the Company with the Securities and Exchange Commission.

Trademarks of NAPCO: NAPCO, StarLink, StarLink Connect, iBridge, iBridge Messenger, iSee Video, LocDown, Lifesaver, Alarm Lock, ContinentalAccess, Marks USA, NAPCO Commercial, Trilogy, Trilogy Network, ArchiTech, SAVI, iSecure

Trademarks of their respective companies: AT&T, Verizon Network Certified, Control4, NASDAQ

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

FORM 10-K

(Mark One)

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended June 30, 2019
or
 Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition period from ___ to ___

Commission File Number 0-10004

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

Delaware
(State or other jurisdiction of
incorporation or organization)

11-2277818
(I.R.S. Employer I.D. Number)

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

11701
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|--|-------------------|---|
| Common Stock, par value \$0.01 per share | NSSC | Nasdaq Stock Market |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of December 31, 2018, the aggregate market value of the common stock of Registrant held by non-affiliates based upon the last sale price of the stock on such date was \$181,841,704.

As of September 10, 2019, 18,477,784 shares of common stock of Registrant were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates information by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Registrant's 2019 Annual Meeting of Stockholders.

PART I

ITEM 1: BUSINESS.

NAPCO Security Technologies, Inc. ("NAPCO" or the "Company") was incorporated in December 1971 in the State of Delaware. Its executive offices are located at 333 Bayview Ave, Amityville NY 11701. Its telephone number is (631) 842-9400.

The Company is a diversified manufacturer of security products, encompassing access control systems, door-locking products, intrusion and fire alarm systems and video surveillance products for commercial and residential use. The Company also provides wireless communication service for intrusion and fire alarm systems. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment.

Website Access to Company Reports

Copies of our filings under the Securities Exchange Act of 1934 (including annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to these reports) are available free of charge on our website (www.napcosecurity.com) on the same day they are electronically filed with the Securities and Exchange Commission.

Products

The Company's products ("Products") are comprised of the following:

The Company designs, engineers, manufactures and markets the software and control panels discussed above. It also buys and resells various identification readers, PC-based computers and various peripheral equipment for access control systems.

Door Security Products. The Company manufactures a variety of door locking devices including microprocessor-based electronic door locks with push button, card reader and bio-metric operation, door alarms, mechanical door locks and simple dead bolt locks. These devices may control a single door or, in the case of some of the Company's microprocessor-based door locks, may be networked with the Company's access control systems and controlled remotely.

Intrusion and Fire Alarm Systems. Alarm systems usually consist of various detectors, a control panel, a digital keypad and signaling equipment. When a break-in occurs, an intrusion detector senses the intrusion and activates a control panel via hard-wired or wireless transmission that sets off the signaling equipment and, in most cases, causes a bell or siren to sound. Communication equipment such as a digital communicator may be used to transmit the alarm signal to a central station or another person selected by a customer.

The Company manufactures and markets the following products for alarm systems:

Automatic Communicators. When a control panel is activated by a signal from an intrusion detector, it activates a communicator that can automatically dial one or more pre-designated telephone numbers utilizing wired ("landline") or cellular communications systems. If programmed to do so, a digital communicator dials the telephone number of a central monitoring station and communicates in computer language to a digital communicator receiver, which signals an alarm message.

Cellular communication devices. A cellular communication device connects to the communicator and is used in lieu of, or in addition to, a landline for communicating with a central monitoring station.

Control Panels. A control panel is the "brain" of an alarm system. When activated by any one of the various types of intrusion detectors, it can activate an audible alarm and/or various types of communication devices.

Combination Control Panels/Digital Communicators and Digital Keypad Systems. A combination control panel, digital communicator and a digital keypad has continued to be the leading configuration in terms of dealer and

consumer preference. Benefits of the combination format include the cost efficiency resulting from a single microcomputer function, as well as the reliability and ease of installation gained from the simplicity and sophistication of micro-computer technology.

Fire Alarm Control Panel. Multi-zone fire alarm control panels, which accommodate an optional digital communicator for reporting to a central station, are also manufactured by the Company.

Area Detectors. The Company's area detectors are both passive infrared heat detectors and combination microwave/passive infrared detectors that are linked to alarm control panels. Passive infrared heat detectors respond to the change in heat patterns caused by an intruder moving within a protected area. Combination units respond to both changes in heat patterns and changes in microwave patterns occurring at the same time.

Cellular communication services. The Company provides cellular access for the cellular communication devices described above. These services are provided and invoiced on a month to month basis.

Access Control Systems. Access control systems consist of one or more of the following: various types of identification readers (e.g. card readers, hand scanners), a control panel, a PC-based computer and electronically activated door-locking devices. When an identification card or other identifying information is entered into the reader, the information is transmitted to the control panel/PC which then validates the data and determines whether or not to grant access by electronically deactivating the door locking device. An electronic log is kept which records various types of data regarding access activity.

Video Surveillance Systems. Video surveillance systems typically consist of one or more video cameras, a control panel and a video monitor or PC. More advanced systems can also include a recording device and some type of remote communication device such as an internet connection to a PC or browser-enabled cell phone. The system allows the user to monitor various locations at once while recorders save the video images for future use. Remote communication devices can allow the user to view and control the system from a remote location. The Company designs, engineers, and markets the software and control panels discussed above. It also buys and resells various video cameras, PC-based computers and peripheral equipment for video surveillance systems.

Peripheral Equipment

The Company also markets peripheral and related equipment manufactured by other companies. Revenues from peripheral equipment have not been significant.

Research and Development

The Company's business involves a high technology element. Research and development ("R&D") costs incurred by the Company are charged to expense as incurred and are included in "Operating expenses" in the consolidated statements of operations. During the fiscal years ended June 30, 2019 and 2018, the Company expended approximately \$7,212,000 and \$6,630,000, respectively, on Company-sponsored research and development activities conducted primarily by its engineering department to develop and improve the Products. The Company intends to continue to conduct a significant portion of its future research and development activities internally.

Employees

As of June 30, 2019, the Company had 1,076 full-time employees.

Marketing

The Company's staff of 58 sales and marketing support employees located at the Company's Amityville offices sells and markets the Products primarily to independent distributors and wholesalers of security alarm and security hardware equipment. Management estimates that these channels of distribution represented approximately 57%, and 54% of the Company's total sales for the fiscal years ended June 30, 2019 and 2018, respectively. The remaining revenues are primarily from installers and governmental institutions. The Company's sales representatives periodically contact existing and potential customers to introduce new products and create demand for those as well as other Company products. These sales

representatives, together with the Company's technical personnel, provide training and other services to wholesalers and distributors so that they can better service the needs of their customers. In addition to direct sales efforts, the Company advertises in technical trade publications and participates in trade shows in major United States and European cities.

In the ordinary course of the Company's business the Company grants extended payment terms to certain customers. The Company had one customer with an accounts receivable balance that comprised 19% and 22% of the Company's accounts receivable at June 30, 2019 and 2018, respectively. Sales to this customer comprised 10% of net sales in each of the fiscal years ended June 30, 2019 and 2018. The Company had another customer with an accounts receivable balance that comprised 11% of the Company's accounts receivable at both June 30, 2019 and 2018. Sales to this customer did not exceed 10% for fiscal years ended June 30, 2019 or 2018. For further discussion on Concentration of Credit Risk see disclosures included in Item 1A and Item 7.

Competition

The security products industry is highly competitive. The Company's primary competitors are comprised of approximately 12 other companies that manufacture and market security equipment to distributors, dealers, central stations and original equipment manufacturers. The Company believes that no one of these competitors is dominant in the industry. Most of these companies have substantially greater financial and other resources than the Company.

The Company competes primarily on the basis of the features, quality, reliability and pricing of, and the incorporation of the latest innovative and technological advances into, its Products. The Company also competes by offering technical support services to its customers. In addition, the Company competes on the basis of its expertise, its proven products, its reputation and its ability to provide Products to customers on a timely basis. The inability of the Company to compete with respect to any one or more of the aforementioned factors could have an adverse impact on the Company's business.

Relatively low-priced "do-it-yourself" alarm system products are available to the public at retail stores. The Company believes that these products compete with the Company only to a limited extent because they appeal primarily to the "do-it-yourself" segment of the market. Purchasers of such systems do not receive professional consultation, installation, service or the sophistication that the Company's Products provide.

Seasonality

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

Raw Materials

The Company prepares specifications for component parts used in the Products and purchases the components from outside sources or fabricates the components itself. These components, if standard, are generally readily available; if specially designed for the Company, there is usually more than one alternative source of supply available to the Company on a competitive basis. The Company generally maintains inventories of all critical components. The Company for the most part is not dependent on any one source for its raw materials. The Company believes that any vendor that is currently the sole source of a component can be replaced without a material impact on the Company.

Sales Backlog

In general, orders for the Products are processed by the Company from inventory. A sales backlog of approximately \$992,000 and \$2,151,000 existed as of June 30, 2019 and 2018, respectively. The Company expects to fill the entire backlog that existed as of June 30, 2019 during fiscal 2020.

Government Regulation

The Company's telephone dialers, microwave transmitting devices utilized in its motion detectors and any new communication equipment that may be introduced from time to time by the Company must comply with standards promulgated by the Federal Communications Commission ("FCC") in the United States and similar agencies in other countries where the Company offers such products, specifying permitted frequency bands of operation, permitted power output and periods of operation, as well as compatibility with telephone lines. Each new Product that is subject to such regulation must be tested for compliance with FCC standards or the standards of such similar governmental agencies. Test reports are submitted to the FCC or such similar agencies for approval. Cost of compliance with these regulations has not been material.

Patents and Trademarks

The Company has been granted several patents and trademarks relating to the Products. While the Company obtains patents and trademarks as it deems appropriate, the Company does not believe that its current or future success is dependent on its patents or trademarks.

Foreign Sales

The revenues and identifiable assets attributable to the Company's domestic and foreign operations for its last two fiscal years are summarized in the following table:

Financial Information Relating to Domestic and Foreign Operations

| | Fiscal Year ended June 30, | |
|---------------------------------|----------------------------|-----------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Sales to external customers(1): | | |
| Domestic | \$100,716 | \$89,490 |
| Foreign | <u>2,216</u> | <u>2,256</u> |
| Total Net Sales | <u>\$102,932</u> | <u>\$91,746</u> |
| | As of June 30, | |
| | 2019 | 2018 |
| Identifiable assets: | | |
| United States | \$59,683 | \$52,928 |
| Dominican Republic (2) | <u>26,225</u> | <u>20,341</u> |
| Total Identifiable Assets | <u>\$85,908</u> | <u>\$73,269</u> |

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

(2) Consists primarily of inventories (2019 = \$22,549; 2018 = \$16,592) and plant and equipment (2019 = \$3,443; 2018 = \$3,462) located at the Company's principal manufacturing facility in the Dominican Republic.

ITEM 1A: RISK FACTORS

The risks described below are among those that could materially and adversely affect the Company's business, financial condition or results of operations. These risks could cause actual results to differ materially from historical results and from any results predicted by any forward-looking statements related to conditions or events that may occur in the future.

Our Business Could Be Materially Adversely Affected as a Result of General Economic and Market Conditions

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

We Are Dependent Upon the Efforts of Richard L. Soloway, Our Chief Executive Officer and There is No Succession Plan in Place

The success of the Company is largely dependent on the efforts of Richard L. Soloway, Chief Executive Officer. The loss of his services could have a material adverse effect on the Company's business and prospects. There is currently no succession plan to address the loss of Mr. Soloway's services.

Competitors May Develop New Technologies or Products in Advance of Us

Our business may be materially adversely affected by the announcement or introduction of new products and services by our competitors, and the implementation of effective marketing or sales strategies by our competitors. The industry in which the Company operates is characterized by constantly improved products. There can be no assurance that competitors will not develop products that are superior to the Company's products. The Company has historically invested approximately 6% to 8% of annual revenues on Research and Development to mitigate this risk. Future success will depend, in part, on our ability to continue to develop and market products and product enhancements cost-effectively. The Company's research and development expenditures are principally targeted at enhancing existing products, and to a lesser extent at developing new ones. Further, there can be no assurance that the Company will not experience additional price competition, and that such competition may not adversely affect the Company's revenues and results of operations.

Our Business Could Be Materially Adversely Affected by the Inability to Maintain Expense Levels Proportionate to Sales Volume

Certain of our expenses are fixed or semi-variable. While expense levels relative to current sales levels result in positive net income and cash flows, if sales levels decrease significantly and we are unable to decrease expenses proportionately, our business may be adversely affected.

Our Business Could Be Materially Adversely Affected as a Result of Housing and Commercial Building Market Conditions

We are subject to the effects of housing and commercial building market conditions. If these conditions deteriorate, resulting in declines in new housing or commercial building starts, existing home or commercial building sales or renovations, our business, results of operations or financial condition could be materially adversely affected, particularly in our intrusion and door locking product lines.

Our Business Could Be Materially Adversely Affected as a Result of Lessening Demand in the Security Market

Our revenue and profitability depend on the overall demand for our products. Delays or reductions in spending, domestically or internationally, for electronic security systems could materially adversely affect demand for our products, which could result in decreased revenues or earnings.

The Markets We Serve Are Highly Competitive and We May Be Unable to Compete Effectively

We compete with approximately 12 other companies that manufacture and market security equipment to distributors, dealers, control stations and original equipment manufacturers. Most of these companies may have substantially greater financial and other resources than the Company. The Company competes primarily on the basis of the features, quality, reliability and pricing of, and the incorporation of the latest innovative and technological advances into, its products. The Company also competes by offering technical support services to its customers. In addition, the Company competes on the basis of its expertise, its proven products, its reputation and its ability to provide products to customers on a timely basis. The inability of the Company to compete with respect to any one or more of the aforementioned factors could have an adverse impact on the Company's business.

Our Business Could be Materially Adversely Affected as a Result of Offering Extended Payment Terms to Customers

We regularly grant credit terms beyond 30 days to certain customers which are described in Note 2 to the Company's consolidated financial statements included in its 2019 Annual Report on Form 10-K. These terms are offered in an effort to keep a full line of our products in-stock at our customers' locations. The longer the terms that are granted, the more risk is inherent in collection of those receivables. We believe that our Provision for doubtful accounts is adequate to account for this inherent risk.

We Rely On Distributors To Sell Our Products And Any Adverse Change In Our Relationship With Our Distributors Could Result In A Loss Of Revenue And Harm Our Business.

We distribute our products primarily through independent distributors and wholesalers of security alarm and security hardware equipment. Our distributors and wholesalers also sell our competitors' products, and if they favor our competitors' products for any reason, they may fail to market our products as effectively or to devote resources necessary to provide effective sales, which would cause our results to suffer. In addition, the financial health of these distributors and wholesalers and our continuing relationships with them are important to our success. Some of these distributors and wholesalers may be unable to withstand adverse changes in business conditions. Our business could be seriously harmed if the financial condition of some of these distributors and wholesalers substantially weakens.

Members of Management and Certain Directors Beneficially Own a Substantial Portion of the Company's Common Stock and May Be in a Position to Determine the Outcome of Corporate Elections

Richard L. Soloway, our Chief Executive Officer, members of management and the Board of Directors beneficially own approximately 38% of the currently outstanding shares of Common Stock. By virtue of such ownership and their positions with NAPCO, they may have the practical ability to determine the election of all directors and control the outcome of substantially all matters submitted to Napco's stockholders.

In addition, NAPCO has a staggered Board of Directors. Such concentration of ownership and the staggered Board could have the effect of making it more difficult for a third party to acquire, or discourage a third party from seeking to acquire, control of NAPCO.

Our Business Could be Materially Adversely Affected by Adverse Tax Consequences of Offshore Operations

We operate on a global basis, with a portion of our operating income generated outside the United States.

We intend to reinvest these earnings in our foreign operations indefinitely, except where we are able to repatriate these earnings to the United States without material incremental tax expense. A significant portion of our assets that result from these earnings remain outside the United States. If these indefinitely reinvested earnings were repatriated into the United States as dividends, we would be subject to additional withholding taxes.

Our Business Could Be Materially Adversely Affected as a Result of the Inability to Maintain Adequate Financing

While our business is currently solely dependent on cash-flows from operations to fund operations and capital expenditures we have an unused credit facility in the event that we need to supplement current cash-flows with outside financing. The credit facility provides for certain financial covenants relating to ratios affected by profit, asset and debt levels. If the

Company's profits, asset or cash-flow levels decline below the minimums required to meet these covenants and we require outside financing, the Company may be materially adversely affected. Effects on the Company could include higher interest costs, reduction in borrowing availability or revocation of these credit facilities. This facility is described in Note 7 to the Company's consolidated financial statements included in its 2019 Annual Report on Form 10-K.

If We are Unable to Identify any Material Weaknesses, the Accuracy and Timing of our Financial Reporting may be Adversely Affected, We May be Unable to Maintain Compliance with Securities Law Requirements Regarding Timely Filing of Periodic Reports in Addition to Applicable Stock Exchange Listing Requirements, and our Stock Price May Decline Materially as a Result.

A material weakness is a significant deficiency, or a combination of significant deficiencies, in internal control over financial reporting such that it is reasonably possible that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis.

At June 30, 2018, we identified a number of significant deficiencies which, in the aggregate, constituted a material weakness. During fiscal 2019, we initiated a number of processes which reduced the number of significant deficiencies and eliminated the material weakness. We cannot assure you that we will not have material weaknesses in the future. If we are unable to successfully identify any material weaknesses that may arise, the accuracy and timing of our financial reporting may be adversely affected, we may be unable to maintain compliance with securities law requirements regarding timely filing of periodic reports in addition to applicable stock exchange listing requirements, and our stock price may decline materially as a result.

Our Business Could Be Materially Adversely Affected by a Weakening of the US Dollar against the Dominican Peso

We are exposed to foreign currency risks due to our operations in the Dominican Republic. We have significant operations in the Dominican Republic, which conducts certain transactions in Dominican pesos. We are subject to the risk that currency exchange rates between the United States and the Dominican Republic will fluctuate significantly, potentially resulting in an increase in some of our expenses when US dollars are transferred to Dominican pesos to pay these expenses.

ITEM 1B: UNRESOLVED STAFF COMMENTS.

Not applicable.

ITEM 2: PROPERTIES.

The Company owns executive offices and production and warehousing facilities at 333 Bayview Avenue, Amityville, New York. This facility consists of a fully-utilized building of approximately 95,000 square foot on a six acre plot. This six-acre plot provides the Company with space for expansion of office, manufacturing and storage capacities. These facilities are pledged as security in the Company's credit facilities with its primary bank.

The Company's foreign subsidiary located in the Dominican Republic, Napco DR, S.A., owns a building of approximately 167,000 square feet of production and warehousing space in the Dominican Republic. That subsidiary also leases the land associated with this building under a 99-year lease expiring in the year 2092 at an annual cost of approximately \$288,000. As of June 30, 2019, a majority of the Company's products were manufactured at this facility, utilizing U.S. quality control standards.

Management believes that these facilities are more than adequate to meet the needs of the Company in the foreseeable future.

ITEM 3: LEGAL PROCEEDINGS.

There are no pending or threatened material legal proceedings to which NAPCO or its subsidiaries or any of their property is subject. The Company is party to an IRS proceeding described under Income Taxes and in Note 6 to the consolidated financial statements.

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.

ITEM 4: MINE SAFETY DISCLOSURE.

Not Applicable.

PART II

ITEM 5: MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Principal Market

NAPCO's Common Stock is traded on the NASDAQ Stock Market, Global Market System, under the symbol NSSC.

Approximate Number of Security Holders

The number of holders of record of NAPCO's Common Stock as of September 10, 2019 was 82 (such number does not include beneficial owners of stock held in nominee name).

Dividend Information

NAPCO has declared no cash dividends during the past two years with respect to its Common Stock.

Equity Compensation Plan Information as of June 30, 2019

| PLAN CATEGORY | NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS (a) | WEIGHTED AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS (b) | NUMBER OF SECURITIES REMAINING AVAILABLE FOR FUTURE ISSUANCE (EXCLUDING SECURITIES REFLECTED IN COLUMN (a)) (c) |
|---|---|---|--|
| Equity compensation plans approved by security holders: | 97,900 | \$11.50 | 822,900 (1) |
| Equity compensation plans not approved by security holders: | — | — | — |
| Total | 97,900 | \$11.50 | 822,900 (1) |

- (1) In December 2018, the stockholders approved the 2018 Non-Employee Stock Option Plan which authorizes the granting of awards, the exercise of which would allow up to an aggregate of 50,000 shares of the Company's common stock to be acquired by the holders of such awards. In December 2012, the stockholders approved the 2012 Employee Stock Option Plan which authorizes the granting of awards, the exercise of which would allow up to an aggregate of 950,000 shares of the Company's common stock to be acquired by the holders of such awards. In December 2012, the stockholders also approved the 2012 Non-Employee Stock Option Plan which authorizes the granting of awards, the exercise of which would allow up to an aggregate of 50,000 shares of the Company's common stock to be acquired by the holders of such awards.

ITEM 6: SELECTED FINANCIAL DATA.

The table below summarizes selected financial information. For further information, refer to the audited consolidated financial statements and the notes thereto beginning on page FS-1 of this report.

| | Fiscal Year Ended and at June 30 | | | | |
|---|---|-------------|-------------|-------------|-------------|
| | (In thousands, except share and per share data) | | | | |
| | <u>2019 (4)</u> | <u>2018</u> | <u>2017</u> | <u>2016</u> | <u>2015</u> |
| <u>Statement of earnings data:</u> | | | | | |
| Net Sales | \$102,932 | \$91,746 | \$87,374 | \$82,513 | \$77,762 |
| Gross Profit (3) | 43,890 | 37,995 | 36,301 | 33,753 | 31,429 |
| Income from Operations | 13,466 | 8,414 | 6,378 | 6,323 | 5,281 |
| Net Income | 12,223 | 7,649 | 5,599 | 5,773 | 4,845 |
| <u>Cash Flow Data:</u> | | | | | |
| Net cash flows provided by operating activities | 8,653 | 7,864 | 2,448 | 9,160 | 3,887 |
| Net cash flows used in investing activities | (1,988) | (1,280) | (1,414) | (693) | (730) |
| Net cash flows used in financing activities | (3,945) | (4,730) | (1,385) | (7,008) | (3,294) |
| <u>Per Share Data:</u> | | | | | |
| Net earnings per common share: | | | | | |
| Basic | \$0.66 | \$0.41 | \$0.30 | \$0.31 | \$0.25 |
| Diluted | \$0.66 | \$0.41 | \$0.30 | \$0.31 | \$0.25 |
| Weighted average common shares outstanding: | | | | | |
| Basic | 18,574,000 | 18,788,000 | 18,809,000 | 18,874,000 | 19,164,000 |
| Diluted | 18,624,000 | 18,825,000 | 18,854,000 | 18,894,000 | 19,169,000 |
| Cash Dividends declared per common share (1) | \$0.00 | \$0.00 | \$0.00 | \$0.00 | \$0.00 |
| <u>Balance sheet data:</u> | | | | | |
| Working capital (2) | \$51,083 | \$44,301 | \$40,798 | \$36,888 | \$35,590 |
| Total assets | 85,908 | 73,269 | 70,862 | 64,769 | 65,037 |
| Long-term debt | -- | -- | 3,500 | 4,500 | 9,100 |
| Stockholders' equity | 71,172 | 63,453 | 56,889 | 51,273 | 46,504 |

- (1) The Company has never paid a dividend on its common stock.
- (2) Working capital is calculated by deducting Current Liabilities from Current Assets.
- (3) Prior period balances have been reclassified to conform with the current period presentation.
- (4) ASC 606-10-50 was adopted on July 1, 2018. See Footnote 2 to the consolidated financial statements.

ITEM 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Overview

The Company is a diversified manufacturer and service provider of security products, encompassing access control systems, door security products, intrusion and fire alarm systems, video surveillance products for commercial and residential use and wireless communication service for intrusion and fire alarm systems. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment. International sales accounted for approximately 2% of our revenues for each of the fiscal years ended June 30, 2019 and 2018. During fiscal 2019, recurring revenue from service was \$17,427,000, representing approximately 17% of Net sales.

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

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

Economic and Other Factors

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

Seasonality

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

Critical Accounting Policies and Estimates

The Company's significant accounting policies are fully described in Notes 1 and 2 to the Company's consolidated financial statements included in its 2019 Annual Report on Form 10-K. Management believes the following critical accounting policies, among others, affect its more significant judgments and estimates used in the preparation of its consolidated financial statements.

Net Sales

The Company is engaged in one major line of business: the development, manufacture, and distribution of security products, encompassing access control systems, door security products, intrusion and fire alarm systems, alarm communication services, and video surveillance products for commercial and residential use. The Company also provides wireless communication service for intrusion and fire alarm systems on a monthly basis. 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. Sales to unaffiliated customers are primarily shipped from the United States. The Company has customers worldwide with major concentrations in North America.

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services.

For product sales the Company typically transfers control at a point in time upon shipment or delivery of the product. For monthly communication services the Company satisfies its performance obligation as the services are rendered and therefore recognizes revenue over the monthly period.

Typically timing of revenue recognition coincides with the timing of invoicing to the customers, at which time the Company has an unconditional right to consideration. As such, the Company typically records a receivable when revenue is recognized.

The contract with the customer states the final terms of the sale, including the description, quantity, and price of each product purchased. Payment for product sales is typically due within 30 and 180 days of the delivery date. Payment for monthly communication services is billed on a monthly basis and is typically due at the beginning of the month of service.

The Company provides limited standard warranty for defective products, usually for a period of 24 to 36 months. The Company accepts returns for such defective products as well as for other limited circumstances. The Company also provides rebates to customers for meeting specified purchasing targets and other coupons or credits in limited circumstances. The Company establishes reserves for the estimated returns, rebates and credits and measures such variable consideration based on the expected value method using an analysis of historical data. Changes to the estimated variable consideration in subsequent periods are not material.

The Company analyzes sales returns and is able to make reasonable and reliable estimates of product returns based on the Company's past history. Estimates for sales returns are based on several factors including actual returns and based on expected return data communicated to it by its customers. Accordingly, the Company believes that its historical returns analysis is an accurate basis for its allowance for sales returns. Actual results could differ from those estimates. As a percentage of gross sales, sales returns, rebates and allowances were 8% and 7% for the fiscal years ended June 30, 2019 and 2018, 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 one customer with an accounts receivable balance that comprised 19% and 22% of the Company's accounts receivable at June 30, 2019 and 2018, respectively. Sales to this customer comprised 10% of net sales in each of the fiscal years ended June 30, 2019 and 2018. The Company had another customer with an accounts receivable balance that comprised 11% of the Company's accounts receivable at June 30, 2019 and June 30, 2018. Sales to this customer did not exceed 10% of net sales in either of the fiscal years ended June 30, 2019 and 2018.

In the ordinary course of business, we have established a reserve for doubtful accounts and customer deductions in the amount of \$88,000 and \$195,000 as of June 30, 2019 and 2018, respectively. Our reserve for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This reserve is based upon the evaluation of accounts receivable agings, specific exposures and historical or anticipated events.

Inventories

Inventories are valued at the lower of cost or net realizable value, with cost being determined on the first-in, first-out (FIFO) method. The reported net value of inventory includes finished saleable products, work-in-process and raw materials that will be sold or used in future periods. Inventory costs include raw materials, direct labor and overhead.

The Company's overhead expenses are applied based, in part, upon estimates of the proportion of those expenses that are related to procuring and storing raw materials as compared to the manufacture and assembly of finished products. These proportions, the method of their application, and the resulting overhead included in ending inventory, are based in part on subjective estimates and actual results could differ from those estimates. In addition, the Company records an inventory obsolescence reserve, which represents the difference between the cost of the inventory and its estimated realizable value, based on various product sales projections. This reserve is calculated using an estimated obsolescence percentage applied to the inventory based on age, historical trends, requirements to support forecasted sales, and the ability to find alternate applications of its raw materials and to convert finished product into alternate versions of the same product to better match customer demand. There is inherent professional judgment and subjectivity made by both production and engineering members of management in determining the estimated obsolescence percentage. In addition, and as necessary, the Company may establish specific reserves for future known or anticipated events. The Company also regularly reviews the period over which its inventories will be converted to sales. Any inventories expected to convert to sales beyond 12 months from the balance sheet date are classified as non-current.

Intangible Assets

Impairment of Long-lived Assets— The Company reviews its long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to future net undiscounted cash flows expected to be generated by the asset group. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. As of June 30, 2019 and 2018, the Company has determined that no impairment of long-lived assets exists.

The Company evaluates its indefinite Intangible Assets for impairment at least on an annual basis and will evaluate them earlier if there are indicators of a potential impairment. Those intangible assets that are classified as other intangibles with indefinite lives are not amortized. Impairment testing is performed in two steps: (i) the Company determines if there is impairment by comparing the fair value of a reporting unit with its carrying value, and (ii) if there is impairment, the Company measures the amount of impairment loss by comparing the implied fair value of intangible assets with the carrying amount of the intangible assets. The Company has concluded that no impairment of intangible assets occurred during the years ended June 30, 2019 and 2018.

Income Taxes

The Company has identified the United States and New York State as its major tax jurisdictions. Fiscal 2016 and forward years are still open for examination. In addition, the Company has a wholly-owned subsidiary which operates in a Free Zone in the Dominican Republic ("DR") and is exempt from DR income tax.

The Company was audited by the Internal Revenue Service ("IRS") for the fiscal year 2016. In July 2019, the Company received Form 4549-A, Income Tax Examination Changes from the IRS proposing an adjustment to income for the fiscal 2016 tax year regarding deemed dividends based on its interpretation under Internal Revenue Code ("IRC") Section 956 arising from the intercompany balances on the books of the Company. The incremental tax liability associated with the income adjustment proposed by the IRS would be approximately \$1.8 million, excluding any interest and penalties. In August 2019, the Company filed a formal protest with the IRS requesting an opportunity to appeal the examination findings to the Appeals Office. The Company strongly believes that the position of the IRS with regard to this matter is inconsistent with the provisions of IRC Section 956 and management believes that the Company will prevail, and that the tax originally paid in fiscal 2016 is correct, as such no additional reserve for this tax uncertainty has been recognized. However, there can be no assurance that this matter will ultimately be resolved in the Company's favor.

For the year ended June 30, 2019, the Company recognized a net income tax expense of \$1,222,000. During the year ending June 30, 2019 the Company decreased its reserve for uncertain income tax positions by \$96,000. The Company's practice is to recognize interest and penalties related to income tax matters in income tax expense and accrued income taxes. As of June 30, 2019, the Company had accrued interest totaling \$0 and \$125,000 of unrecognized net tax benefits that, if recognized, would favorably affect the Company's effective income tax rate in

any future period. The Company claims research and development (“R&D”) tax credits on eligible research and development expenditures. The R&D tax credits are recognized as a reduction to income tax expense.

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

Liquidity and Capital Resources

The Company's cash on hand as of June 30, 2018 combined with proceeds from operating activities during fiscal 2019 were adequate to meet the Company's capital expenditure and financing needs during fiscal 2019. The Company's primary internal source of liquidity is the cash flow generated from operations. The primary source of external financing is a revolving credit facility of \$11,000,000 (the “Revolving Credit Facility”) which expires in June 2021. As of June 30, 2019, \$0 was outstanding under this revolving line of credit. As of June 30, 2019, the Company's unused sources of funds consisted principally of \$8,028,000 in cash and cash equivalents and \$11,000,000 unused balance available under its revolving line of credit.

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

During the year ended June 30, 2019, the Company utilized its cash on hand at June 30, 2018 (\$5,308,000) and a portion of its cash provided by operations (\$678,000 of \$8,653,000) to repurchase treasury stock (\$3,998,000) and purchase property, plant and equipment (\$1,988,000).

As of June 30, 2019, the Company’s primary outside source of financing consisted of a revolving credit facility of \$11,000,000 (the “Revolving Credit Facility”) which expires in June 2021. As of June 30, 2019 and 2018, there were no outstanding balances under the Revolving Credit Facility. This facility is described more fully in Note 7 to the consolidated financial statements.

The Company believes its current working capital, anticipated 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.

The Company takes into consideration several factors in measuring its liquidity, including the ratios set forth below:

| | As of June 30, | |
|----------------------|----------------|-------------|
| | <u>2019</u> | <u>2018</u> |
| Current Ratio | 4.6 to 1 | 5.7 to 1 |
| Sales to Receivables | 4.0 to 1 | 4.0 to 1 |
| Total debt to equity | 0.0 to 1 | 0.0 to 1 |

As of June 30, 2019, the Company had no material commitments for capital expenditures or inventory purchases other than purchase orders issued in the normal course of business. On April 26, 1993, the Company's foreign subsidiary entered into a 99-year land lease of approximately 4 acres of land in the Dominican Republic, on which the Company’s principle manufacturing facility is located, at an annual cost of approximately \$288,000.

Working Capital. Working capital increased by \$6,782,000 to \$51,083,000 at June 30, 2019 from \$44,301,000 at June 30, 2018. Working capital is calculated by deducting Current Liabilities from Current Assets.

Accounts Receivable. Accounts Receivable increased by \$3,232,000 to \$25,970,000 at June 30, 2019 as compared to \$22,738,000 at June 30, 2018. The increase in Accounts Receivable was due primarily to an increase in sales for the quarter ended June 30, 2019 as compared to the same quarter a year ago.

Inventories. Inventories, which include both current and non-current portions, increased by \$5,904,000 to \$34,838,000 at June 30, 2019 as compared to \$28,934,000 at June 30, 2018. The increase was due primarily to the Company building up levels of its recently introduced and soon to be introduced new products.

Accounts Payable and Accrued Expenses. Accounts payable and accrued expenses, not including income taxes payable, increased by \$4,715,000 to \$13,824,000 as of June 30, 2019 as compared to \$9,109,000 at June 30, 2018. This increase is primarily due to the increase in inventory as described above.

Off-Balance Sheet Arrangements

The Company does not maintain any off-balance sheet arrangements.

Results of Operations

Fiscal 2019 Compared to Fiscal 2018

| | <u>Fiscal year ended June 30. (dollars in thousands)</u> | | |
|---|--|-------------|-----------------------------------|
| | <u>2019</u> | <u>2018</u> | <u>% Increase/ (decrease)</u> |
| Net sales | \$102,932 | \$91,746 | 12.2% |
| Gross profit | 43,890 | 37,995 | 15.5% |
| Gross profit as a % of net sales | 42.6% | 41.4% | 2.9% |
| Research and development | 7,212 | 6,630 | 8.8% |
| Selling, general and administrative | 23,212 | 22,951 | 1.1% |
| Selling, general and administrative as a % of net sales | 22.6% | 25.0% | (9.6)% |
| Income from operations | 13,466 | 8,414 | 60.0% |
| Interest expense, net | 21 | 81 | (74.1)% |
| Provision for income taxes | 1,222 | 684 | 78.7% |
| Net income | 12,223 | 7,649 | 59.8% |

Net sales in fiscal 2019 increased by \$11,186,000 to \$102,932,000 as compared to \$91,746,000 in fiscal 2018. The increase in net sales was primarily due to increased sales of the Company's alarm communication services (\$5,425,000), NAPCO brand intrusion products (\$2,809,000), Alarm Lock brand door-locking products (\$2,246,000), Marks brand door-locking products (\$568,000), and Continental brand access control products (\$138,000).

The Company's gross profit increased by \$5,895,000 to \$43,890,000 or 42.6% of net sales in fiscal 2019 as compared to \$37,995,000 or 41.4% of net sales in fiscal 2018. Gross profit was primarily affected by the increase in net sales as discussed above as partially offset by increased salary and freight expenses.

Research and Development expenses increased by \$582,000 to \$7,212,000 in fiscal 2019 as compared to \$6,630,000 in fiscal 2018. The increase was due primarily to the addition of personnel.

Selling, general and administrative expenses for fiscal 2019 increased by \$261,000 to \$23,212,000 as compared to \$22,951,000 in fiscal 2018. Selling, general and administrative expenses as a percentage of net sales decreased to 22.6% in fiscal 2019 from 25.0% in fiscal 2018. The increase in dollars resulted primarily from increases in employee compensation. The decrease as a percentage of sales was primarily the result of the percentage increase in sales exceeding that of the increase in Selling, general and administrative expenses.

Interest expense for fiscal 2019 decreased by \$60,000 to \$21,000 as compared to \$81,000 for the same period a year ago. The decrease was due to the Company eliminating its outstanding debt during fiscal 2018. The remaining interest relates to charges on the unused portion of the Company's revolving line of credit.

The Company's provision for income taxes for fiscal 2019 increased by \$538,000 to \$1,222,000 as compared to \$684,000 for the same period a year ago. The Company's effective tax rate remained relatively constant at 9% for fiscal 2019 as compared to 8% for fiscal 2018.

Net income for fiscal 2019 increased by \$4,574,000 to \$12,223,000 as compared to \$7,649,000 in fiscal 2018. This resulted primarily from the items discussed above.

Forward-looking Information

This Annual Report on Form 10-K and the information incorporated by reference may include "Forward-Looking Statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act of 1934. The Company intends the Forward-Looking Statements to be covered by the Safe Harbor Provisions for Forward-Looking Statements. All statements regarding the Company's expected financial position and operating results, its business strategy, its financing plans and the outcome of any contingencies are Forward-Looking Statements. The Forward-Looking Statements are based on current estimates and projections about our industry and our business. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," or variations of such words and similar expressions are intended to identify such Forward-Looking Statements. The Forward-Looking Statements are subject to risks and uncertainties that could cause actual results to differ materially from those set forth or implied by any Forward-Looking Statements. For example, the Company is highly dependent on its Chief Executive Officer for strategic planning. If he is unable to perform his services for any significant period of time, the Company's ability to grow could be adversely affected. In addition, factors that could cause actual results to differ materially from the Forward-Looking Statements include, but are not limited to, uncertain economic, military and political conditions in the world, our ability to maintain and develop competitive products, adverse tax consequences of offshore operations, the ability to maintain adequate financing and significant fluctuations in the exchange rate between the Dominican Peso and the U.S. Dollar. The Company's Risk Factors are discussed in more detail in Item 1A.

ITEM 7A: 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 based on the prime rate or LIBOR as described in the agreement. The Company is affected by market risk exposure primarily through the effect of changes in interest rates on amounts payable by the Company under these credit facilities.

All foreign sales transactions by the Company are denominated in U.S. dollars. As such, the Company has shifted foreign currency exposure onto its foreign customers. As a result, if exchange rates move against foreign customers, the Company could experience difficulty collecting unsecured accounts receivable, the cancellation of existing orders or the loss of future orders. The foregoing could materially adversely affect the Company's business, financial condition and results of operations. We are also exposed to foreign currency risk relative to expenses incurred in Dominican Pesos ("RD\$"), the local currency of the Company's production facility in the Dominican Republic. The result of a 10% strengthening or weakening in the U.S. dollar to the RD\$ would result in an annual increase or decrease in income from operations of approximately \$700,000.

ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

a. Financial Statements: Financial statements required pursuant to this Item are presented on pages FS-1 through FS-25 of this report as follows:

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

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Management Report on Internal Control

Management has prepared and is responsible for our consolidated financial statements and related notes. Management is also responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Napco Technologies, Inc. (the “Company”) internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with the authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company’s assets that could have a material effect on the financial statements.

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements prepared for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.

Management conducted an assessment of the effectiveness of internal control over financial reporting based on the framework in *Internal Control – Integrated Framework (2013)* as issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management determined that as of June 30, 2019, the Company did maintain effective internal control over financial reporting.

The effectiveness of our internal control over financial reporting as of June 30, 2019 has been audited by Baker Tilly Virchow Krause, LLP, an independent registered public accounting firm, as stated in their report included herein.

Report of Independent Registered Public Accounting Firm

To the stockholders and board of directors of Napco Security Technologies, Inc. and Subsidiaries:

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Napco Security Technologies, Inc. and Subsidiaries (the "Company") as of June 30, 2019 and 2018, the related consolidated statements of income, stockholders' equity, and cash flows, for each of the two years in the period ended June 30, 2019, and the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of June 30, 2019, based on criteria established in *Internal Control – Integrated Framework: (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of June 30, 2019 and 2018, and the results of their operations and their cash flows for each of the two years in the period ended June 30, 2019, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2019, based on criteria established in *Internal Control – Integrated Framework: (2013)* issued by COSO.

Adoption of New Accounting Standard

As discussed in Notes 1 and 2 to the consolidated financial statements, the Company has changed its method of accounting for revenue for the year ended June 30, 2019 due to the adoption of FASB Accounting Standards Update No. 2014-09 (Topic 606), Revenue from Contracts with Customers, and related amendments.

Basis for Opinions

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We have served as the Company's auditor since 2009.

/s/ BAKER TILLY VIRCHOW KRAUSE, LLP
Melville, New York
September 13, 2019

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NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands except for share and per share data)

| | June 30, | |
|---|----------|----------|
| | 2019 | 2018 |
| <u>CURRENT ASSETS</u> | | |
| Cash and cash equivalents | \$8,028 | \$5,308 |
| Accounts receivable, net of allowance for doubtful accounts of \$88 and \$195 at June 30, 2019 and 2018, respectively, and other reserves | 25,970 | 22,738 |
| Inventories | 29,576 | 24,533 |
| Prepaid expenses and other current assets | 1,881 | 1,124 |
| Total Current Assets | 65,455 | 53,703 |
| Inventories - non-current | 5,262 | 4,401 |
| Deferred income taxes | - | 564 |
| Property, plant and equipment, net | 7,694 | 6,791 |
| Intangible assets, net | 7,232 | 7,545 |
| Other assets | 265 | 265 |
| TOTAL ASSETS | \$85,908 | \$73,269 |
| <u>CURRENT LIABILITIES</u> | | |
| Accounts payable | \$5,135 | \$4,807 |
| Accrued expenses | 6,273 | 2,112 |
| Accrued salaries and wages | 2,416 | 2,190 |
| Accrued income taxes | 548 | 293 |
| Total Current Liabilities | 14,372 | 9,402 |
| Deferred income taxes | 72 | - |
| Accrued income taxes | 292 | 414 |
| Total Liabilities | 14,736 | 9,816 |
| COMMITMENTS AND CONTINGENCIES (Note 11) | | |
| <u>STOCKHOLDERS' EQUITY</u> | | |
| Common Stock, par value \$0.01 per share; 40,000,000 shares authorized; 21,227,094 and 21,204,327 shares issued; and 18,477,784 and 18,729,082 shares outstanding, respectively | 212 | 212 |
| Additional paid-in capital | 17,103 | 16,890 |
| Retained earnings | 70,924 | 59,420 |
| Less: Treasury Stock, at cost (2,749,310 and 2,475,245 shares, respectively) | (17,067) | (13,069) |
| TOTAL STOCKHOLDERS' EQUITY | 71,172 | 63,453 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$85,908 | \$73,269 |

See accompanying notes to consolidated financial statements.

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NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

| | Fiscal Year ended June 30, | |
|--|--|------------|
| | 2019 | 2018 |
| Net sales: | (in thousands except for share and per share data) | |
| Equipment revenues | \$85,505 | \$79,744 |
| Service revenues | 17,427 | 12,002 |
| | 102,932 | 91,746 |
| Cost of sales: | | |
| Equipment related expenses | 55,240 | 50,962 |
| Service related expenses | 3,802 | 2,789 |
| | 59,042 | 53,751 |
| Gross Profit | 43,890 | 37,995 |
| Research and development | 7,212 | 6,630 |
| Selling, general, and administrative expenses | 23,212 | 22,951 |
| | 30,424 | 29,581 |
| Operating Income | 13,466 | 8,414 |
| Other expense: | | |
| Interest expense, net | 21 | 81 |
| Income before Provision for Income Taxes | 13,445 | 8,333 |
| Provision for Income Taxes | 1,222 | 684 |
| Net Income | \$12,223 | \$7,649 |
| Income per share: | | |
| Basic | \$0.66 | \$0.41 |
| Diluted | \$0.66 | \$0.41 |
| Weighted average number of shares outstanding: | | |
| Basic | 18,574,000 | 18,788,000 |
| Diluted | 18,624,000 | 18,825,000 |

See accompanying notes to consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

Fiscal Years ended June 30, 2019 and 2018

(in thousands except for share data)

| | Common Stock | | Additional Paid-in Capital | Treasury Stock | | Retained Earnings | Total |
|----------------------------------|-------------------------------|--------------|----------------------------------|---------------------|-------------------|----------------------|-----------------|
| | Number of Shares Issued | Amount | | Number of Shares | Amount | | |
| Balances at June 30, 2017 | 21,174,507 | \$212 | \$16,638 | (2,329,850) | \$(11,732) | \$51,771 | \$56,889 |
| Repurchase of treasury shares | - | - | - | (145,395) | (1,337) | - | (1,337) |
| Stock options exercised | 29,820 | - | 106 | - | - | - | 106 |
| Stock-based compensation expense | - | - | 146 | - | - | - | 146 |
| Net income | - | - | - | - | - | 7,649 | 7,649 |
| | | | | | | | |
| Balances at June 30, 2018 | 21,204,327 | \$212 | \$16,890 | (2,475,245) | \$(13,069) | \$59,420 | \$63,453 |
| Implementation of ASC606 | - | - | - | - | - | (719) | (719) |
| Repurchase of treasury shares | - | - | - | (274,065) | (3,998) | - | (3,998) |
| Stock options exercised | 22,767 | - | 53 | - | - | - | 53 |
| Stock-based compensation expense | - | - | 160 | - | - | - | 160 |
| Net income | - | - | - | - | - | 12,223 | 12,223 |
| | | | | | | | |
| Balances at June 30, 2019 | <u>21,227,094</u> | <u>\$212</u> | <u>\$17,103</u> | <u>(2,749,310)</u> | <u>\$(17,067)</u> | <u>\$70,924</u> | <u>\$71,172</u> |

See accompanying notes to consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Fiscal Year ended June 30, | |
|--|----------------------------|---------|
| | 2019 | 2018 |
| | (in thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$12,223 | \$7,649 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,409 | 1,409 |
| Provision for doubtful accounts | (26) | 40 |
| Change to inventory obsolescence reserve | (272) | 788 |
| Deferred income taxes | 755 | 80 |
| Non-cash stock based compensation expense | 160 | 146 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (1,440) | (2,503) |
| Inventories | (5,991) | 857 |
| Prepaid expenses and other current assets | 318 | 206 |
| Other assets | (11) | (151) |
| Accounts payable, accrued expenses, accrued salaries and wages, accrued income taxes | 1,528 | (656) |
| Net Cash Provided by Operating Activities | 8,653 | 7,865 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of property, plant, and equipment | (1,988) | (1,280) |
| Net Cash Used in Investing Activities | (1,988) | (1,280) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Principal payments on long-term debt | - | (3,500) |
| Proceeds from stock option exercises | 53 | 106 |
| Cash paid for purchase of treasury stock | (3,998) | (1,337) |
| Net Cash Used in Financing Activities | (3,945) | (4,731) |
| Net Change in Cash and Cash Equivalents | 2,720 | 1,854 |
| CASH AND CASH EQUIVALENTS - Beginning | 5,308 | 3,454 |
| CASH AND CASH EQUIVALENTS - Ending | \$8,028 | \$5,308 |
| SUPPLEMENTAL CASH FLOW INFORMATION | | |
| Interest paid, net | \$23 | \$82 |
| Income taxes paid | \$262 | \$186 |
| Surrender of common shares | 8 | 11 |

See accompanying notes to consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Nature of Business:

Napco Security Technologies, Inc. and Subsidiaries (the "Company") is a diversified manufacturer of security products, encompassing access control systems, door-locking products, intrusion and fire alarm systems and video surveillance products for commercial and residential use. The Company also provides wireless communication service for intrusion and fire alarm systems. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment.

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

Significant Accounting Policies:

Principles of Consolidation

The consolidated financial statements include the accounts of Napco Security Technologies, Inc. and all of its wholly-owned subsidiaries. All inter-company balances and transactions have been eliminated in consolidation.

Accounting Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent gains and losses at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Critical estimates include management's judgments associated with reserves for sales returns and allowances, allowance for doubtful accounts, inventory reserves, intangible assets and income taxes. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The methods and assumptions used to estimate the fair value of the following classes of financial instruments were: Current Assets and Current Liabilities - The carrying amount of cash and cash equivalents, certificates of deposits, current receivables and payables and certain other short-term financial instruments approximate their fair value as of June 30, 2019 and 2018 due to their short-term maturities.

Cash and Cash Equivalents

Cash and cash equivalents include approximately \$460,000 of short-term time deposits at June 30, 2019 and 2018. The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. The Company has cash balances in banks in excess of the maximum amount insured by the FDIC and other international agencies as of June 30, 2019 and 2018. The Company has not historically experienced any credit losses with balances in excess of FDIC limits.

Accounts Receivable

Accounts receivable is stated net of the reserves for doubtful accounts of \$88,000 and \$195,000 as of June 30, 2019 and 2018, respectively. Our reserves for doubtful accounts are subjective critical estimates that have a direct impact on reported net earnings. These reserves are based upon the evaluation of our accounts receivable aging, specific exposures, sales levels and historical trends.

Inventories

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

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

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

Property, Plant, and Equipment

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

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

Intangible Assets

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

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

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

| | June 30, 2019 | | | June 30, 2018 | | |
|------------------------|-----------------|--------------------------|----------------|-----------------|--------------------------|----------------|
| | Cost | Accumulated amortization | Net book value | Cost | Accumulated amortization | Net book value |
| Customer relationships | \$9,800 | \$(8,468) | \$1,332 | \$9,800 | \$(8,155) | \$1,645 |
| Trade name | 5,900 | -- | 5,900 | 5,900 | -- | 5,900 |
| | <u>\$15,700</u> | <u>\$(8,468)</u> | <u>\$7,232</u> | <u>\$15,700</u> | <u>\$(8,155)</u> | <u>\$7,545</u> |

Amortization expense for intangible assets subject to amortization was approximately \$313,000 and \$371,000 for the fiscal years ended June 30, 2019 and 2018, respectively. Amortization expense for each of the next five fiscal years is estimated to be as follows: 2020 - \$264,000; 2021 - \$223,000; 2022 - \$188,000; 2023 - \$159,000; and 2024 - \$134,000. The weighted

average remaining amortization period for intangible assets was 9.1 years and 10.1 years at June 30, 2019 and 2018, respectively.

Long-Lived Assets

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

Revenue Recognition

The Company recognizes revenue in accordance with Accounting Standards Codification (“ASC”), Topic 606, *Revenue from Contracts with Customers*, which the Company adopted effective July 1, 2018. Accordingly, the Company recognizes revenue when its customers obtain control of its products or services, in an amount that reflects the consideration that the Company expects to receive in exchange for those goods and services. See Note 2 – Revenue Recognition for additional accounting policies and transition disclosures.

Advertising and Promotional Costs

Advertising and promotional costs are included in "Selling, General and Administrative" expenses in the consolidated statements of income and are expensed as incurred. Advertising expense for fiscal years ended June 30, 2019 and 2018 was \$2,047,000 and \$2,011,000, respectively.

Research and Development Costs

Research and development costs incurred by the Company are charged to expense as incurred and are included in operating expenses in the consolidated statements of income. Company-sponsored research and development expense for the fiscal years ended June 30, 2019 and 2018 was \$7,212,000 and \$6,630,000, respectively.

Income Taxes

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

Net Income Per Share

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

The following provides a reconciliation of information used in calculating the per share amounts for the fiscal years ended June 30 (in thousands, except per share data):

| | Net Income | | Weighted Average Shares | | Net Income per Share | |
|--------------------------------|-----------------|----------------|-------------------------|---------------|----------------------|----------------|
| | 2019 | 2018 | 2019 | 2018 | 2019 | 2018 |
| Basic EPS | \$12,223 | \$7,649 | 18,574 | 18,788 | \$ 0.66 | \$ 0.41 |
| Effect of Dilutive Securities: | | | | | | |
| Stock Options | -- | -- | 50 | 37 | -- | -- |
| Diluted EPS | <u>\$12,223</u> | <u>\$7,649</u> | <u>18,624</u> | <u>18,825</u> | <u>\$ 0.66</u> | <u>\$ 0.41</u> |

Options to purchase 2,957 and 217 shares of common stock were excluded for the fiscal years ended June 30, 2019 and 2018, respectively, and were not included in the computation of Diluted EPS because their inclusion would be anti-dilutive. These options were still outstanding at the end of the respective periods.

Stock-Based Compensation

The Company has established three share incentive programs as discussed in Note 8.

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

Stock-based compensation costs of \$160,000 and \$146,000 were recognized for the fiscal years ended June 30, 2019 and 2018, respectively.

Foreign Currency

The Company has determined the functional currency of all foreign subsidiaries is the U.S Dollar. All foreign operations are considered a direct and integral part or extension of the Company's operations. The day-to-day operations of all foreign subsidiaries are dependent on the economic environment of the U.S Dollar. Therefore, no realized and unrealized gains and losses associated with foreign currency translation is recorded for the fiscal years ended June 30, 2019 or 2018.

Comprehensive Income

For the fiscal years ended June 30, 2019 and 2018, the Company's operations did not give rise to material items includable in comprehensive income, which were not already included in net income. Accordingly, the Company's comprehensive income approximates its net income for all periods presented.

Segment Reporting

The Company's reportable operating segments are determined based on the Company's management approach. The management approach is based on the way that the chief operating decision maker organizes the segments within an enterprise for making operating decisions and assessing performance. The Company's results of operations are reviewed by the chief operating decision maker on a consolidated basis and the Company operates in only one segment. The Company has presented required geographical data in Note 12.

Shipping and Handling Revenues and Costs

The Company records the amount billed to customers for shipping and handling in net sales (\$430,000 and \$476,000 in the fiscal years ended June 30, 2019 and 2018, respectively) and classifies the costs associated with these revenues in cost of sales (\$1,115,000 and \$988,000 in the fiscal years ended June 30, 2019 and 2018, respectively).

Recently Issued and Adopted Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606) (ASU 2014-09), which amended the accounting standards for revenue recognition. This standard superseded all prior revenue recognition standards and requires entities to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

The Company adopted this ASU effective July 1, 2018. See Note 2, Revenue Recognition for additional accounting policy and transition disclosures.

In February 2016, the FASB issued authoritative guidance that requires lessees to account for most leases on their balance sheets with the liability being equal to the present value of the lease payments. The right-of-use asset will be based on the lease liability adjusted for certain costs such as direct costs. Lease expense will be recognized similar to current accounting guidance with operating leases resulting in a straight-line expense and financing leases resulting in a front-loaded expense similar to the current accounting for capital leases. This guidance becomes effective for the Company's fiscal 2020 first quarter, with early adoption permitted. This guidance must be adopted using a modified retrospective transition approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, and provides for certain practical expedients. We anticipate the adoption of this standard will result in an increase in our right of use assets and lease liabilities recorded on our consolidated balance sheets on July 1, 2019. The Company does not believe the adoption of this guidance will have a material impact on its consolidated results of operations or cash flows.

NOTE 2 – Revenue Recognition and Contracts with Customers

Adoption

On July 1, 2018, the Company adopted new guidance on revenue from contracts with customers using the modified retrospective method applied to contracts that were not completed as of July 1, 2018. Results for reporting periods beginning after July 1, 2018 are presented under the new guidance, while prior period amounts are not adjusted and continue to be reported in accordance with previous guidance.

The Company recorded a net decrease to opening retained earnings of approximately \$719,000 (net of tax benefit of \$191,000) as of July 1, 2018, for the cumulative impact of adopting the new guidance. The impact primarily related to the change in the recognition and measurement of certain types of variable consideration, which resulted in the increase in sales allowance reserves (i.e. refund liabilities) by a net of \$1,627,000 and increased other assets (i.e. return related assets) by approximately \$716,000. As of June 30, 2019, the Company included return-related assets of approximately \$820,000 in other current assets.

Also, due to the adoption of the new standard, the Company classified certain reserves in respect of refund liabilities that were previously presented as a reduction from receivables, to current liabilities amounting to approximately \$3,524,000 as of June 30, 2019. Further, amounts related to promotion payments to customers are now classified as a reduction of sales.

The impact of applying this ASU for the fiscal year ended June 30, 2019 resulted in an immaterial change in product sales.

Net Sales

The Company is engaged in one major line of business: the development, manufacture, and distribution of security products, encompassing access control systems, door security products, intrusion and fire alarm systems, alarm communication services, and video surveillance products for commercial and residential use. The Company also provides wireless communication service for intrusion and fire alarm systems on a monthly basis. 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. Sales to unaffiliated customers are primarily shipped from the United States. The Company has customers worldwide with major concentrations in North America.

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services.

For product sales the Company typically transfers control at a point in time upon shipment or delivery of the product. For monthly communication services the Company satisfies its performance obligation as the services are rendered and therefore recognizes revenue over the monthly period.

Typically timing of revenue recognition coincides with the timing of invoicing to the customers, at which time the Company has an unconditional right to consideration. As such, the Company typically records a receivable when revenue is recognized.

The contract with the customer states the final terms of the sale, including the description, quantity, and price of each product purchased. Payment for product sales is typically due within 30 and 180 days of the delivery date. Payment for monthly communication services is billed on a monthly basis and is typically due at the beginning of the month of service.

The Company provides limited standard warranty for defective products, usually for a period of 24 to 36 months. The Company accepts returns for such defective products as well as for other limited circumstances. The Company also provides rebates to customers for meeting specified purchasing targets and other coupons or credits in limited circumstances. The Company establishes reserves for the estimated returns, rebates and credits and measures such variable consideration based on the expected value method using an analysis of historical data. Changes to the estimated variable consideration in subsequent periods are not material.

The Company analyzes sales returns and is able to make reasonable and reliable estimates of product returns based on the Company's past history. Estimates for sales returns are based on several factors including actual returns and based on expected return data communicated to it by its customers. Accordingly, the Company believes that its historical returns analysis is an accurate basis for its allowance for sales returns. Actual results could differ from those estimates. As a percentage of gross sales, sales returns, rebates and allowances were 8% and 7% for the fiscal years ended June 30, 2019 and 2018, respectively.

In accordance with ASC 606-10-50, the Company disaggregates revenue from contracts with customers into major product lines. The Company determines that disaggregating revenue into these categories achieves the disclosure objective to depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. As noted in the accounting policy footnote, the Company's business consists of one operating segment. Following is the disaggregation of revenues based on major product lines (in thousands):

| | <u>Fiscal year ended June 30,</u> | |
|-------------------------------------|-----------------------------------|-----------------|
| | <u>2019</u> | <u>2018</u> |
| Major Product Lines: | | |
| Intrusion and access alarm products | \$31,557 | \$28,610 |
| Door locking devices | 53,948 | 51,134 |
| Services | <u>17,427</u> | <u>12,002</u> |
| Total Revenues | <u>\$102,932</u> | <u>\$91,746</u> |

NOTE 3 - Business and Credit Concentrations

An entity is more vulnerable to concentrations of credit risk if it is exposed to risk of loss greater than it would have had if it mitigated its risk through diversification of customers. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance. The Company had one customer with an accounts receivable balance that comprised 19% and 22% of the Company's accounts receivable at June 30, 2019 and 2018, respectively. Sales

to this customer comprised 10% of net sales in each of the fiscal years ended June 30, 2019 and 2018. The Company had another customer with an accounts receivable balance that comprised 11% of the Company's accounts receivable at June 30, 2019 and June 30, 2018. Sales to this customer did not exceed 10% of net sales in either of the fiscal years ended June 30, 2019 and 2018.

NOTE 4 - Inventories

Inventories, net of reserves are valued at lower of cost (first-in, first-out method) or net realizable value. The Company regularly reviews parts and finished goods inventories on hand and, when necessary, records a provision for excess or obsolete inventories. The Company also regularly reviews the period over which its inventories will be converted to sales. Any inventories expected to convert to sales beyond 12 months from the balance sheet date are classified as non-current.

Inventories, net of reserves consist of the following as of June 30, (in thousands):

| | <u>2019</u> | <u>2018</u> |
|---|-----------------|-----------------|
| Component parts | \$21,543 | \$16,495 |
| Work-in-process | 5,377 | 4,491 |
| Finished product | <u>7,918</u> | <u>7,948</u> |
| | <u>\$34,838</u> | <u>\$28,934</u> |
| Classification of inventories, net of reserves: | | |
| Current | \$29,576 | \$24,533 |
| Non-current | <u>5,262</u> | <u>4,401</u> |
| | <u>\$34,838</u> | <u>\$28,934</u> |

NOTE 5 - Property, Plant, and Equipment

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

| | <u>June 30,</u> | | |
|---|-----------------|-----------------|--|
| | <u>2019</u> | <u>2018</u> | <u>Useful Life in Years</u> |
| Land | \$904 | \$904 | -- |
| Buildings | 8,911 | 8,911 | 30 to 40 |
| Molds and dies | 7,333 | 7,275 | 3 to 5 |
| Furniture and fixtures | 2,691 | 2,599 | 5 to 10 |
| Machinery and equipment | 23,915 | 22,996 | 7 to 10 |
| Building improvements | <u>1,625</u> | <u>706</u> | Shorter of the lease term or life of asset |
| | 45,379 | 43,391 | |
| Less: accumulated depreciation and amortization | <u>(37,685)</u> | <u>(36,600)</u> | |
| | <u>\$7,694</u> | <u>\$6,791</u> | |

Depreciation and amortization expense on property, plant, and equipment was approximately \$1,085,000 and \$1,031,000 in fiscal 2019 and 2018, respectively.

NOTE 6 - Income Taxes

The provision for income taxes is comprised of the following (in thousands):

| | For the Years Ended June 30, | |
|-------------------------------|---------------------------------|---------------------|
| | 2019 | 2018 |
| Current income taxes: | | |
| Federal | \$310 | \$567 |
| State | 141 | 37 |
| | <u>451</u> | <u>604</u> |
| Deferred income tax provision | 771 | 80 |
| Provision for income taxes | <u><u>\$1,222</u></u> | <u><u>\$684</u></u> |

A reconciliation of the U.S. Federal statutory income tax rate to our actual effective tax rate on earnings before income taxes is as follows for the years ended June 30, (dollars in thousands):

| | 2019 | | 2018 | |
|---|-----------------------|---------------------------|---------------------|---------------------------|
| | Amount | % of Pre-tax Income | Amount | % of Pre-tax Income |
| Tax at Federal statutory rate | \$2,822 | 21.0% | \$2,296 | 27.6% |
| Increases (decreases) in taxes resulting from: | | | | |
| Meals and entertainment | 49 | 0.3% | 56 | 0.6% |
| State income taxes, net of Federal income tax benefit | 103 | 0.8% | 29 | 0.3% |
| Foreign source income not subject to tax | (1,219) | (9.1)% | (1,895) | (22.7)% |
| R&D Credit | (408) | (3.0)% | (314) | (3.8)% |
| Transition tax | 0 | 0.0% | 381 | 4.6% |
| Foreign withholding tax | 0 | 0.0% | 256 | 3.1% |
| Release of accrued tax reserves | (151) | (1.1)% | 0 | 0% |
| U.S. Federal Tax rate reduction | 0 | 0.0% | (136) | (1.6)% |
| Audit Settlements | 12 | 0.1% | 0 | 0% |
| Other, net | 14 | 0.1% | 11 | 0.1% |
| Effective tax rate | <u><u>\$1,222</u></u> | <u><u>9.1%</u></u> | <u><u>\$684</u></u> | <u><u>8.2%</u></u> |

Deferred tax assets and deferred tax liabilities at June 30, 2019 and 2018 are as follows (in thousands):

| | Deferred Tax Assets (Liabilities) | |
|----------------------------------|-----------------------------------|---------------------|
| | 2019 | 2018 |
| Accounts receivable | \$17 | \$17 |
| Inventories | 246 | 437 |
| Accrued liabilities | 250 | 233 |
| Stock based compensation expense | 36 | 15 |
| Intangibles | (502) | (324) |
| R&D credit | 378 | 781 |
| Property, plant and equipment | (407) | (339) |
| Revenue reserves | 319 | 0 |
| Other deferred tax liabilities | (409) | (256) |
| | (72) | 564 |
| Valuation allowance | -- | -- |
| Net deferred tax liabilities | <u><u>\$(72)</u></u> | <u><u>\$564</u></u> |

The Company has identified the United States and New York State as its major tax jurisdictions. Fiscal 2016 and forward years are still open for examination. In addition, the Company has a wholly-owned subsidiary which operates in a Free Zone in the Dominican Republic (“DR”) and is exempt from DR income tax.

The Company was audited by the Internal Revenue Service (“IRS”) for the fiscal year 2016. In July 2019, the Company received Form 4549-A, Income Tax Examination Changes from the IRS proposing an adjustment to income for the fiscal 2016 tax year regarding deemed dividends based on its interpretation under Internal Revenue Code (“IRC”) Section 956 arising from the intercompany balances on the books of the Company. The incremental tax liability associated with the income adjustment proposed by the IRS would be approximately \$1.8 million, excluding any interest and penalties. In August 2019 the Company filed a formal protest with the IRS requesting an opportunity to appeal the examination findings to the Appeals Office. The Company believes that the position of the IRS with regard to this matter is inconsistent with the provisions of IRC Section 956 and management believes that the Company will prevail, and that the tax originally paid in fiscal 2016 is correct, as such no additional reserve for this tax uncertainty has been recognized. However, there can be no assurance that this matter will ultimately be resolved in the Company's favor.

The provision for income taxes represents Federal, Foreign, and State and Local income taxes. The effective rate differs from statutory rates due to the effect of tax rates in foreign jurisdictions, state and local income taxes, tax benefit of R&D credits, certain nondeductible expenses, release of uncertain tax positions for R&D tax credits and global intangible low-taxed income (“GILTI”).

On December 22, 2017, the U.S. government passed the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act is comprehensive tax legislation effective January 1, 2018 that implements complex changes to the U.S. tax code including, but not limited to, the reduction of the corporate tax rate from 35% to 21% and includes provisions to tax GILTI. We are subject to the GILTI provisions effective for fiscal year ended June 30, 2019. The Tax Act also imposed a one-time transition tax on its unremitted foreign earnings. ASC 740 requires filers to record the effects of tax law changes in the period enacted. However, the SEC issued Staff Accounting Bulletin No. 118 (“SAB 118”), that permits filers to record provisional amounts during a measurement period ending no later than one year from the date of the Act’s enactment. As of March 31, 2019, the Company finalized its accounting for the income tax effects of the Tax Act and no additional expense was recorded since the final transition tax expense was equal to the \$381,000 provisional expense reported in the fiscal year ended June 30, 2018. The net section 965 tax liability was \$442,000, which is payable over 8 years.

During the year ending June 30, 2019 the Company decreased its reserve for uncertain income tax positions by \$96,000. The Company’s practice is to recognize interest and penalties related to income tax matters in income tax expense and accrued income taxes. As of June 30, 2019, the Company had accrued interest totaling \$0 and \$125,000 of unrecognized

net tax benefits that, if recognized, would favorably affect the Company's effective income tax rate in any future period. The Company does not expect that its unrecognized tax benefits will significantly change within the next twelve months. The Company claims R&D tax credits on eligible research and development expenditures. The R&D tax credits are recognized as a reduction to income tax expense.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

| | <u>Tax</u> | <u>Interest</u> | <u>Total</u> |
|--|--------------|-----------------|--------------|
| Balance of gross unrecognized tax benefits as of July 1, 2017 | \$183 | \$ -- | \$183 |
| Increases to unrecognized tax benefits resulting from the generation of additional R&D credits | <u>38</u> | <u>--</u> | <u>38</u> |
| Balance of gross unrecognized tax benefits as of June 30, 2018 | \$221 | \$ -- | \$221 |
| Decrease to unrecognized tax benefits resulting from the release of R&D credits due to the IRS audit | (151) | | (151) |
| Increases to unrecognized tax benefits resulting from the generation of additional R&D credits | <u>55</u> | <u>--</u> | <u>55</u> |
| Balance of gross unrecognized tax benefits as of June 30, 2019 | <u>\$125</u> | <u>\$ --</u> | <u>\$125</u> |

The Company plans to permanently reinvest a substantial portion of its foreign earnings and as such has not provided withholding tax on the permanently reinvested earnings. The Company has accrued \$408,000 for withholding taxes on undistributed earnings that are not permanently reinvested. As of June 30, 2019 the Company had approximately \$31.3 million of undistributed earnings of foreign subsidiaries.

NOTE 7 - Long-Term Debt

As of June 30, 2019, long-term debt consisted of a revolving line of credit of \$11,000,000 ("Agreement") which expires in June 2021.

Outstanding balances and interest rates as of June 30, 2019 and June 30, 2018 are as follows (dollars in thousands):

| | <u>June 30, 2019</u> | | <u>June 30, 2018</u> | |
|--------------------------|----------------------|----------------------|----------------------|----------------------|
| | <u>Outstanding</u> | <u>Interest Rate</u> | <u>Outstanding</u> | <u>Interest Rate</u> |
| Revolving line of credit | \$ -- | n/a | \$ -- | n/a |

The Agreement also provides for a LIBOR-based interest rate option of LIBOR plus 1.15% to 2.00%, depending on the ratio of outstanding debt to EBITDA, which is to be measured and adjusted quarterly, a prime rate-based option of the prime rate plus 0.25% and other terms and conditions as more fully described in the Agreement. In addition, the Agreement provides for availability to be limited to the lesser of \$11,000,000 or the result of a borrowing base formula based upon the Company's Accounts Receivables and Inventory values net of certain deductions. The Company's obligations under the Agreement continue to be secured by all of its assets, including but not limited to, deposit accounts, accounts receivable, inventory, and the Company's corporate headquarters in Amityville, NY, equipment and fixtures and intangible assets. In addition, the Company's wholly-owned subsidiaries, with the exception of the Company's foreign subsidiaries, have issued guarantees and pledges of all of their assets to secure the Company's obligations under the Agreement. All of the outstanding common stock of the Company's domestic subsidiaries and 65% of the common stock of the Company's foreign subsidiaries has been pledged to secure the Company's obligations under the Agreement.

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

NOTE 8 - Stock Options

The Company follows ASC 718 (“Share-Based Payment”), which requires that all share based payments to employees, including stock options, be recognized as compensation expense in the consolidated financial statements based on their fair values and over the requisite service period. For the fiscal years ended June 30, 2019 and 2018, the Company recorded non-cash compensation expense of \$160,000 (\$0.01 per basic and diluted share) and \$146,000 (\$0.01 per basic and diluted share), respectively, relating to stock-based compensation

2012 Employee Stock Option Plan

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

Under the 2012 Employee Plan, stock options may be granted to valued employees with a term of up to 10 years at an exercise price equal to or greater than the fair market value on the date of grant and are exercisable, in whole or in part, at 20% per year beginning on the date of grant. An option granted under this plan shall vest in full upon a “change in control” as defined in the plan. At June 30, 2019, 72,500 stock options were outstanding, 33,800 stock options were exercisable and 792,900 stock options were available for grant under this plan.

The fair value of each option granted during fiscal 2019 and 2018 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | <u>2019</u> | <u>2018</u> |
|--------------------------|-------------|-------------|
| Risk-free interest rates | 2.5% - 3.1% | 2.4% |
| Expected lives | 10 years | 10 years |
| Expected volatility | 48% - 52% | 52% |
| Expected dividend yields | 0% | 0% |

The Company uses a weighted-average expected stock-price volatility assumption that is a combination of both current and historical implied volatilities of the underlying stock. The implied volatilities were obtained from publicly available data sources. For the weighted-average expected option life assumption, the Company considers the exercise behavior of past grants. The average risk-free interest rate is based on the U.S. Treasury Bond rate for the expected term of the options and the average dividend yield is based on historical experience.

The following table reflects activity under the 2012 Plan for the fiscal years ended June 30:

| | 2019 | | 2018 | |
|--|---------------|---------------------------------|---------------|---------------------------------|
| | Options | Weighted average exercise price | Options | Weighted average exercise price |
| Outstanding, beginning of year | 57,200 | \$7.09 | 70,600 | \$5.84 |
| Granted | 29,000 | 16.59 | 25,000 | 9.01 |
| Terminated | 0 | 0 | (4,000) | 9.15 |
| Exercised | (13,700) | 6.42 | (34,400) | 5.68 |
| Outstanding, end of year | <u>72,500</u> | <u>\$11.01</u> | <u>57,200</u> | <u>\$7.09</u> |
| Exercisable, end of year | <u>33,800</u> | <u>\$8.05</u> | <u>30,400</u> | <u>\$6.55</u> |
| Weighted average fair value at grant date of options granted | \$ 9.15 | | \$ 5.61 | |
| Total intrinsic value of options exercised | \$ 160,000 | | \$ 187,000 | |
| Total intrinsic value of options outstanding | \$ 1,353,000 | | \$ 324,000 | |
| Total intrinsic value of options exercisable | \$ 731,000 | | \$ 246,000 | |

The following table summarizes information about stock options outstanding under the 2012 Employee Plan at June 30, 2019:

| Range of exercise prices | Options outstanding | | | Options exercisable | |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
| | Number outstanding | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable | Weighted average exercise price |
| \$4.37-\$22.89 | 72,500 | 7.6 | \$11.01 | 33,800 | \$8.05 |
| | <u>72,500</u> | <u>7.6</u> | <u>\$11.01</u> | <u>33,800</u> | <u>\$8.05</u> |

As of June 30, 2019, there was \$297,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Employee Plan. 29,000 and 25,000 options were granted during the fiscal years ended June 30, 2019 and 2018, respectively. 8,200 of the 13,700 stock options exercised during the fiscal year ended June 30, 2019 were settled by exchanging 3,106 shares of the Company's common stock which were retired and returned to unissued status upon receipt. 18,000 of the 34,400 stock options exercised during the fiscal year ended June 30, 2018 were settled by exchanging 7,940 shares of the Company's common stock which were retired and returned to unissued status upon receipt. The total fair value of the options vesting during the fiscal years ended June 30, 2019 and 2018 under this plan was \$95,000 and \$86,000, respectively. \$31,000 and \$106,000 was received from option exercises for the fiscal years ended June 30, 2019 and 2018, respectively, and the actual tax benefit realized for the tax deductions from option exercises was \$0 for each of these periods.

2012 Non-Employee Stock Option Plan

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

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

At June 30, 2019, 10,200 stock options were outstanding, 3,000 stock options were exercisable and no further stock options were available for grant under this plan.

The fair value of each option granted during fiscal 2018 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | <u>2018</u> |
|--------------------------|-------------|
| Risk-free interest rates | 2.4% |
| Expected lives | 10 years |
| Expected volatility | 52% |
| Expected dividend yields | 0% |

The following table reflects activity under the 2012 Non-Employee Plan for the fiscal years ended June 30:

| | <u>2019</u> | | <u>2018</u> | |
|--|-----------------|--|----------------|--|
| | <u>Options</u> | <u>Weighted average exercise price</u> | <u>Options</u> | <u>Weighted average exercise price</u> |
| Outstanding, beginning of year | 27,800 | \$6.85 | 14,200 | \$4.69 |
| Granted | -- | -- | 15,000 | 8.70 |
| Terminated | (1,800) | 8.70 | -- | -- |
| Exercised | <u>(15,800)</u> | <u>5.91</u> | <u>(1,400)</u> | <u>4.73</u> |
| Outstanding, end of year | <u>10,200</u> | <u>\$7.99</u> | <u>27,800</u> | <u>\$6.85</u> |
| Exercisable, end of year | <u>3,000</u> | <u>\$6.27</u> | <u>13,800</u> | <u>\$5.61</u> |
| Weighted average fair value at grant date of options granted | | n/a | \$ 5.55 | |
| Total intrinsic value of options exercised | \$ 192,000 | | \$ 14,000 | |
| Total intrinsic value of options outstanding | \$ 221,000 | | \$ 217,000 | |
| Total intrinsic value of options exercisable | \$ 70,000 | | \$ 125,000 | |

The following table summarizes information about stock options outstanding under the 2012 Non-Employee Plan at June 30, 2019:

| <u>Range of exercise prices</u> | <u>Options outstanding</u> | | | <u>Options exercisable</u> | |
|-------------------------------------|-------------------------------|--|--|-------------------------------|--|
| | <u>Number outstanding</u> | <u>Weighted average remaining contractual life</u> | <u>Weighted average exercise price</u> | <u>Number exercisable</u> | <u>Weighted average exercise price</u> |
| \$4.37 - \$8.70 | <u>10,200</u> | <u>7.8</u> | <u>\$7.99</u> | <u>3,000</u> | <u>\$6.27</u> |
| | <u>10,200</u> | <u>7.8</u> | <u>\$7.99</u> | <u>3,000</u> | <u>\$6.27</u> |

As of June 30, 2019, there was \$50,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Non-Employee Plan. 0 and 15,000 options were granted during the fiscal years ended June 30, 2019 and 2018, respectively. 14,600 of the 15,800 stock options exercised during the fiscal year ended June 30, 2019 were settled by exchanging 4,832 shares of the Company's common stock which were retired and returned to unissued status upon receipt. The 1,400 stock options exercised during the fiscal year ended June 30, 2018 were settled by exchanging 452 shares of the Company's common stock which were retired and returned to unissued status upon receipt and the actual tax benefit realized for the tax deductions from option exercises was \$0 for each of these periods. The total

fair value of the options vesting during each of the fiscal years ended June 30, 2019 and 2018 under this plan was \$22,000 and \$39,000, respectively.

2018 Non-Employee Stock Option Plan

In December 2018, the stockholders approved the 2018 Non-Employee Stock Option Plan (the “2018 Non-Employee Plan”). This plan authorizes the granting of awards, the exercise of which would allow up to an aggregate of 50,000 shares of the Company's common stock to be acquired by the holders of such awards. Under this plan, the Company may grant stock options to non-employee directors and consultants to the Company and its subsidiaries.

Under the 2018 Non-Employee Plan, stock options may be granted with a term of up to 10 years at an exercise price equal to or greater than the fair market value on the date of grant and are exercisable in whole or in part at 20% per year beginning on the date of grant. An option granted under this plan shall vest in full upon a “change in control” as defined in the plan. At June 30, 2019, 15,200 stock options were outstanding, 2,400 stock options were exercisable and 30,000 stock options were available for grant under this plan.

The fair value of each option granted during the fiscal year ended June 30, 2019 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | <u>2019</u> |
|--------------------------|-------------|
| Risk-free interest rates | 2.9% |
| Expected lives | 10 years |
| Expected volatility | 50% |
| Expected dividend yields | 0% |

The following table reflects activity under the 2018 Employee plan for the fiscal year ended June 30, 2019:

| | <u>2019</u> | |
|--|----------------|--|
| | <u>Options</u> | <u>Weighted average exercise price</u> |
| Outstanding, beginning of year | -- | \$ -- |
| Granted | 20,000 | 16.20 |
| Terminated/Lapsed | (3,200) | 16.20 |
| Exercised | (1,600) | 16.20 |
| | <u>15,200</u> | <u>\$16.20</u> |
| Outstanding, end of year | <u>15,200</u> | <u>\$16.20</u> |
| Exercisable, end of year | <u>2,400</u> | <u>\$16.20</u> |
| Weighted average fair value at grant date of options granted | \$ 10.24 | |
| Total intrinsic value of options exercised | \$ 24,000 | |
| Total intrinsic value of options outstanding | \$ 205,000 | |
| Total intrinsic value of options exercisable | \$ 32,000 | |

As of June 30, 2019, there was \$164,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2018 Non-Employee Plan. 20,000 options were granted during the fiscal years ended June 30, 2019. 800 of the 1,600 stock options exercised during the fiscal year ended June 30, 2019 were settled by exchanging 395 shares of the Company’s common stock which were retired and returned to unissued status upon receipt and the actual tax benefit realized for the tax deductions from option exercises was \$0 for each of these periods. The total fair value of the options vesting during the fiscal year ended June 30, 2019 under this plan was \$41,000.

NOTE 9 – Stockholders’ Equity Transactions

On September 16, 2014 the Company’s board of directors authorized the repurchase of up to 1 million of the approximately 19.4 million shares of the Company’s common stock outstanding. The repurchase will be made from time to time in the open market or in privately negotiated transactions subject to market conditions and the market price of the common stock. Relative to the loan agreement described in Note 6, the Company’s lender gave its consent to this stock repurchase plan. During the fiscal year ended June 30, 2019 the Company repurchased 274,065 shares of its outstanding common stock at a weighted average price of \$14.59. Shares repurchased through June 30, 2019 are included in the Company’s Treasury Stock as of June 30, 2019.

During fiscal 2019, certain employees and Directors exercised incentive stock options under the Company’s 2012 Plan totaling 31,100 shares. 23,600 of these exercises were completed as cashless exercises as allowed for under the Plans, where the exercise shares are issued by the Company in exchange for shares of the Company’s common stock that are owned by the optionees. The number of shares surrendered by the optionees was 8,333 and was based upon the per share price on the effective date of the option exercise.

During fiscal 2018, certain employees and Directors exercised incentive stock options under the Company’s 2012 and 2002 Plans totaling 40,800 shares. 24,400 of these exercises were completed as cashless exercises as allowed for under the Plans, where the exercise shares are issued by the Company in exchange for shares of the Company’s common stock that are owned by the optionees. The number of shares surrendered by the optionees was 11,207 and was based upon the per share price on the effective date of the option exercise.

NOTE 10 - 401(k) Plan

The Company maintains a 401(k) plan (“the Plan”) that covers all U.S. non-union employees with one or more years of service and is qualified under Sections 401(a) and 401(k) of the Internal Revenue Code. Company contributions to this plan are discretionary and totaled \$133,000 and \$132,000 for the years ended June 30, 2019 and 2018, respectively.

NOTE 11 - Commitments and Contingencies

Leases

The Company is committed under various operating leases, not including the land lease discussed below, which do not extend beyond fiscal 2023. Minimum lease payments through the expiration dates of these leases, with the exception of the land leases referred to below, are as follows:

| <u>Year Ending June 30,</u> | <u>Amount</u> |
|-----------------------------|------------------------|
| 2020 | \$27,000 |
| 2021 | 26,000 |
| 2022 | 23,000 |
| 2023 | <u>9,000</u> |
| Total | <u><u>\$85,000</u></u> |

Rent expense, with the exception of the land lease referred to below, totaled approximately \$42,000 and \$35,000, for the fiscal years ended June 30, 2019 and 2018, respectively.

Land Lease

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

Litigation

In the normal course of business, the Company is a party to claims and/or litigation. Management believes that the

settlement of such claims and/or litigation, considered in the aggregate, will not have a material adverse effect on the Company's financial position and results of operations.

Employment Agreements

As of June 30, 2019, the Company was obligated under three employment agreements and one severance agreement. The employment agreements are with the Company's CEO, Senior Vice President of Sales and Marketing ("the SVP of Sales") and the Senior Vice President of Engineering ("the SVP of Engineering"). The employment agreement with the CEO provides for an annual salary of \$752,000, as adjusted for inflation; incentive compensation as may be approved by the Board of Directors from time to time and a termination payment in an amount up to 299% of the average of the prior five calendar year's compensation, subject to certain limitations, as defined in the agreement. The employment agreement renews annually in August unless either party gives the other notice of non-renewal at least six months prior to the end of the applicable term. The employment agreement with the SVP of Sales expires in October 2020 and provides for an annual salary of \$334,000, a bonus arrangement for fiscal 2019 and, if terminated by the Company without cause, severance of nine months' salary and continued company-sponsored health insurance for six months from the date of termination. The employment agreement with the SVP of Engineering expires in August 2020 and provides for an annual salary of \$302,000, a bonus arrangement for fiscal 2019 and, if terminated by the Company without cause, severance of nine month's salary and continued company-sponsored health insurance for six months from the date of termination. The severance agreement is with the Senior Vice President of Operations and Finance and provides for, if terminated by the Company without cause or within three months of a change in corporate control of the Registrant, severance of nine month's salary, continued company-sponsored health insurance for six months from the date of termination and certain non-compete and other restrictive provisions.

NOTE 12 - Geographical Data

The Company is engaged in one major line of business: the development, manufacture, and distribution of security products, encompassing access control systems, door-locking products, intrusion and fire alarm systems and video surveillance products for commercial and residential use. The Company also provides wireless communication service for intrusion and fire alarm systems. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment. Sales to unaffiliated customers are primarily shipped from the United States. The Company has customers worldwide with major concentrations in North America.

Financial Information Relating to Domestic and Foreign Operations

| | Fiscal Year ended June 30, | |
|---------------------------------|----------------------------|-----------------|
| | 2019 | 2018 |
| | (in thousands) | |
| Sales to external customers(1): | | |
| Domestic | \$100,716 | \$89,490 |
| Foreign | 2,216 | 2,256 |
| Total Net Sales | <u>\$102,932</u> | <u>\$91,746</u> |
| | As of June 30, | |
| | 2019 | 2018 |
| Identifiable assets: | | |
| United States | \$59,683 | \$52,928 |
| Dominican Republic (2) | 26,225 | 20,341 |
| Total Identifiable Assets | <u>\$85,908</u> | <u>\$73,269</u> |

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

(2) Consists primarily of inventories (2019 = \$22,549; 2018 = \$16,592) and fixed assets (2019 = \$3,443; 2018 = \$3,462) located at the Company's principal manufacturing facility in the Dominican Republic.

NOTE 13 – Subsequent Events

The Company has evaluated subsequent events occurring after the date of the consolidated financial statements for events requiring recording or disclosure in the consolidated financial statements.

ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None

ITEM 9A: CONTROL AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. At the conclusion of the period ended June 30, 2019, 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 as of June 30, 2019.

Management's Annual Report on Internal Control Over Financial Reporting. Management's Report on Internal Control over Financial Reporting is set forth on page FS-1.

Audit Opinion on Internal Control over Financial Reporting. The effectiveness of the Company's internal control over financial reporting has been audited by Baker Tilly Virchow Krause, LLP an independent registered public accounting firm, as stated in their report, which is included herein on page FS-2.

Limitations on Internal Control. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Board of Directors of the Company has an Audit Committee comprised of three non-management directors. Currently there is a vacancy resulting from the death of Arnold Blumenthal. The Committee meets periodically with financial management and the independent auditors to review accounting, control, audit and financial reporting matters. Baker Tilly Virchow Krause, LLP has full and free access to the Audit Committee, with and without the presence of management.

Changes in Internal Control over Financial Reporting. During the quarterly period ending June 30, 2018, we identified a material weakness in our internal control over financial reporting regarding controls related to a lack of supervision and review to ensure proper internal control over financial reporting. During the fiscal year ended June 30, 2019, we initiated a process that remediated that material weakness.

ITEM 9B: OTHER INFORMATION

None

PART III

ITEM 10: DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information about our directors appearing in the Company's Definitive Proxy Statement for the 2019 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K ("Proxy Statement") under the heading "Election of Directors", is incorporated herein by reference.

We have adopted a Code of Ethics which applies to our senior executive and financial officers, among others. The Code is posted on our website, www.napcosecurity.com, under the "Investors – Other" caption. We intend to make all required disclosures regarding any amendment to, or waiver of, a provision of the Code of Ethics for senior executive and financial officers by posting such information on our website.

The information appearing in the Proxy Statement relating to the members of the Audit Committee and the Audit Committee financial expert under the headings "Corporate Governance and Board Matters – Board Structure and Committee Composition" and "Corporate Governance and Board Matters – Board Structure and Committee Composition – Audit Committee" and the information appearing in the Proxy Statement under the heading "Delinquent Section 16(c) Beneficial Ownership Reporting Compliance" is incorporated herein by this reference.

The information set forth in the Proxy Statement under the heading "Information Concerning Executive Officers" is incorporated herein by reference.

ITEM 11: EXECUTIVE COMPENSATION

The information appearing in the Proxy Statement under the heading "Executive Compensation" and the information appearing in the Proxy Statement relating to the compensation of directors under the caption "Compensation of Directors" is incorporated herein by this reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information appearing in the Proxy Statement under the heading "Beneficial Ownership of Common Stock" is incorporated herein by this reference.

Information regarding Equity Compensation Plan Information as of June 30, 2019 is included in Item 5.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information of Directors," "Corporate Governance and Board Matters – Board Structure and Committee Composition," "Corporate Governance – Policy with Respect to Related Person Transactions," and "Executive Compensation – Certain Transactions" is incorporated herein by this reference appearing in the Proxy Statement under the headings "Corporate Governance and Board Matters – Independence

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information appearing in the Proxy Statement under the headings "Principal Accountant Fees" and "Policy on Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services of Independent Auditors" is incorporated herein by this reference.

PART IV

ITEM 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

Omitted

Upon any request of any shareholder of the Company, the Company will provide such shareholder a copy of the Company's Annual Report Form 10-K for 2018, including the financial statements and schedules thereto, filed with the Security and Exchange Commission. Any such request should be directed to Secretary, NAPCO Security Technologies, Inc., 333 Bayview Avenue, Amityville, New York, 11701. There will be no charge for such reports unless one or more exhibits thereto are requested, in which case the Company's reasonable expenses of furnishing such exhibits requested may be charged.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

September 13, 2019

NAPCO SECURITY TECHNOLOGIES, INC.

(Registrant)

By: /s/RICHARD SOLOWAY

*Richard Soloway
Chairman of the Board of
Directors, President and Secretary
(Principal Executive Officer)*

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and the dates indicated.

| <u>Signature</u> | <u>Title</u> | <u>Date</u> |
|--|---|--------------------|
| <u>/s/RICHARD SOLOWAY</u> Richard Soloway | Chairman of the Board of Directors, President and Secretary and Director (Principal Executive Officer) | September 13, 2019 |
| <u>/s/KEVIN S. BUCHEL</u> Kevin S. Buchel | Senior Vice President of Operations and Finance and Treasurer and Director (Principal Financial and Accounting Officer) | September 13, 2019 |
| <u>/s/PAUL STEPHEN BEEBER</u> Paul Stephen Beeber | Director | September 13, 2019 |
| <u>/s/RANDY B. BLAUSTEIN</u> Randy B. Blaustein | Director | September 13, 2019 |
| <u>/s/DONNA SOLOWAY</u> Donna Soloway | Director | September 13, 2019 |
| <u>/s/ANDREW J. WILDER</u> Andrew J. Wilder | Director | September 13, 2019 |

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NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

NON-GAAP MEASURES OF PERFORMANCE* (unaudited)

(In thousands, except share and per share data)

| | Three months ended June 30, | | Twelve months ended June 30, | |
|---|--------------------------------|------------|---------------------------------|------------|
| | 2019 | 2018 | 2019 | 2018 |
| Net income (GAAP) | \$4,728 | \$3,697 | \$12,223 | \$7,649 |
| Add back provision for income taxes | 35 | 566 | 1,222 | 684 |
| Add back interest and other expense | 3 | 14 | 21 | 81 |
| Operating income (GAAP) | 4,766 | 4,277 | 13,466 | 8,414 |
| Adjustments for non-GAAP measures of performance: | | | | |
| Add back amortization of acquisition-related intangibles | 78 | 93 | 313 | 371 |
| Add back stock-based compensation expense | 8 | 4 | 160 | 145 |
| Adjusted non-GAAP operating income | 4,852 | 4,374 | 13,939 | 8,930 |
| Add back depreciation and other amortization | 299 | 291 | 1,096 | 1,039 |
| Adjusted EBITDA (earnings before interest, taxes, depreciation and amortization) | \$5,151 | \$4,665 | \$15,035 | \$9,969 |
| Adjusted EBITDA* per Diluted Share | \$0.28 | \$0.25 | \$0.81 | \$0.53 |
| Weighted average number of Diluted Shares outstanding | 18,534,000 | 18,769,000 | 18,624,000 | 18,825,000 |

* Non-GAAP Information

Non-GAAP Information. Certain non-GAAP measures are included above, including EBITDA, non-GAAP operating income and Adjusted EBITDA. We define EBITDA as GAAP net income plus income tax expense (benefit), net interest expense, non-cash stock-based expense and depreciation and amortization expense. Non-GAAP operating income does not include amortization of intangibles or stock-based compensation expense. These non-GAAP measures are provided to enhance the user's overall understanding of our financial performance. By excluding these charges our non-GAAP results provide information to management and investors that is useful in assessing NAPCO's core operating performance and in comparing our results of operations on a consistent basis from period to period. The presentation of this information is not meant to be a substitute for the corresponding financial measures prepared in accordance with generally accepted accounting principles. Investors are encouraged to review the reconciliation of GAAP to non-GAAP financial measures included in the above.

annual report

2019



NASDAQ:NSSC

Officers

Richard L. Soloway
Chairman, President
and C.E.O.

Kevin S. Buchel
Senior Vice President of
Operations and Finance,
Treasurer and C.F.O.

Jorge D. Hevia
Senior Vice President
of Sales
and Marketing

Michael Carrieri
Senior Vice President
of Engineering

Alfred DePierro
Vice President
of Engineering
Microcomputer Applications

Common Stock Listing

Nasdaq Global
Market System®
(Symbol—"NSSC")

Directors

Richard L. Soloway
Chairman, President and C.E.O.

Paul Stephen Beeber
Attorney

Randy B. Blaustein, Esq.
Tax Attorney

Kevin S. Buchel
Senior Vice President of
Operations and Finance,
Treasurer and C.F.O.

Donna A. Soloway
Security Industry Publicist

Robert A. Ungar, Esq.
President of
Robert A. Ungar Associates, Inc.
Lobbying, Media and
Fire Service Industry

Andrew J. Wilder
Officer of Israeloff,
Trattner & Company
(Certified Public Accountants)

Primary Bank

HSBC Bank USA
534 Broadhollow Road
Melville, NY 11747

Investor Relations

Copies of the Company's
Annual Report, Forms 10-K and
10-Q and other information filed
with the Securities and Exchange
Commission may be obtained
directly from the Corporation
by contacting:

NAPCO
Security Technologies, Inc.
333 Bayview Avenue
Amityville, NY 11701

Attention:
Corporate Secretary

Independent Accountants

Baker Tilly Virchow Krause, LLP
125 Baylis Road
Melville, NY 11747-3823

Legal Counsel

Forman & Shapiro LLP
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New York, NY 10105

Transfer Agent

Continental Stock
Transfer & Trust Co.
1 State Street
New York, NY 10004

www.napcosecurity.com