NAPCO SECURITY TECHNOLOGIES, INC
Form 10-Q
February 08, 2019

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED: **DECEMBER 31, 2018**

OR

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM __________ TO __________.

Commission File number: 0-10004

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

Delaware (State or other jurisdiction of incorporation of organization)	11-2277818 (IRS Employer Identification Number)
333 Bayview Avenue Amityville, New York (Address of principal executive offices)	11701 (Zip Code)

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

(Former name, former address and former fiscal year if changed from last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x 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 x Non-accelerated filer ¨ Smaller reporting company x 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 x

Number of shares outstanding of each of the issuer’s classes of common stock, as of: February 7, 2019

COMMON STOCK, $.01 PAR VALUE PER SHARE 18,470,032

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2018 (unaudited)	June 30, 2018
	(in thousands, except share data)	
CURRENT ASSETS		
Cash and cash equivalents	$ 7,921	$ 5,308
Accounts receivable, net of allowance for doubtful accounts of $182 and $195 at December 31, 2018 and June 30, 2018, respectively	19,845	22,738
Inventories, net	27,116	24,533
Prepaid expenses and other current assets	1,634	1,124
Total Current Assets	56,516	53,703
Inventories - non-current, net	6,067	4,401
Deferred income taxes	655	564
Property, plant and equipment, net	7,405	6,791
Intangible assets, net	7,388	7,545
Other assets	270	265
TOTAL ASSETS	$ 78,301	$ 73,269
CURRENT LIABILITIES		
Accounts payable	$ 4,994	$ 4,807
Accrued expenses	5,481	2,112
Accrued salaries and wages	2,166	2,190
Accrued income taxes	601	293
Total Current Liabilities	13,242	9,402
Accrued income taxes	414	414
Total Liabilities	13,656	9,816
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common Stock, par value $0.01 per share; 40,000,000 shares authorized; 21,219,342 and 21,204,327 shares issued; and 18,557,704 and 18,729,082 shares outstanding, respectively	212	212
Additional paid-in capital	17,066	16,890
Retained earnings	63,074	59,420
Less: Treasury Stock, at cost (2,661,638 and 2,475,245 shares, respectively)	(15,707)	(13,069)
TOTAL STOCKHOLDERS' EQUITY	64,645	63,453

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 78,301	$ 73,269

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

	Three Months ended December 31,	
	2018	2017
	(in thousands, except for share and per share data)	
Net sales:		
Equipment revenues	$ 20,685	$ 18,269
Service revenues	4,144	2,843
	24,829	21,112
Cost of sales:		
Equipment related expenses	13,203	11,933
Service related expenses	955	700
	14,158	12,633
Gross Profit	10,671	8,479
Research and development	1,762	1,639
Selling, general, and administrative expenses	5,615	5,674
Operating Income	3,294	1,166
Other expense:		
Interest expense, net	6	22
Income before Provision for Income Taxes	3,288	1,144
Provision (benefit) for Income Taxes	419	(89)
Net Income	$ 2,869	$ 1,233
Income per share:		
Basic	$ 0.15	$ 0.07
Diluted	$ 0.15	$ 0.07
Weighted average number of shares outstanding:		
Basic	18,603,000	18,849,000
Diluted	18,649,000	18,883,000

See accompanying notes to condensed consolidated financial statements.

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NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

	Six Months ended December 31,	
	2018	2017
	(in thousands, except for share and per share data)	
Net sales:		
Equipment revenues	$ 40,275	$ 36,855
Service revenues	7,930	5,431
	48,205	42,286
Cost of sales:		
Equipment related expenses	26,210	24,024
Service related expenses	1,765	1,297
	27,975	25,321
Gross Profit	20,230	16,965
Research and development	3,507	3,246
Selling, general, and administrative expenses	11,670	11,494
Operating Income	5,053	2,225
Other expense:		
Interest expense, net	13	48
Income before Provision for Income Taxes	5,040	2,177
Provision for Income Taxes	667	54
Net Income	$ 4,373	$ 2,123
Income per share:		
Basic	$ 0.23	$ 0.11
Diluted	$ 0.23	$ 0.11
Weighted average number of shares outstanding:		
Basic	18,665,000	18,848,000
Diluted	18,713,000	18,881,000

See accompanying notes to condensed consolidated financial statements.

NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Six Months ended December 31,	
	2018	2017
	(in thousands, except share data)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 4,373	$ 2,123
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	668	672
(Recovery of) provision for doubtful accounts	(13)	20
Deferred income taxes	100	(817)
Non-cash stock based compensation expense	152	136
Changes in operating assets and liabilities:		
Accounts receivable	4,671	2,894
Inventories	(4,608)	(1,287)
Prepaid expenses and other current assets	565	190
Other assets	(11)	(151)
Accounts payable, accrued expenses, accrued salaries and wages, accrued income taxes	449	(956)
Net Cash Provided by Operating Activities	6,346	2,824
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property, plant, and equipment	(1,119)	(651)
Net Cash Used in Investing Activities	(1,119)	(651)
CASH FLOWS FROM FINANCING ACTIVITIES		
Principal payments on long-term debt	—	(1,500)
Proceeds from stock option exercises	24	16
Cash paid for purchase of treasury stock	(2,638)	(194)
Net Cash Used in Financing Activities	(2,614)	(1,678)
Net Change in Cash and Cash Equivalents	2,613	495
CASH AND CASH EQUIVALENTS - Beginning	5,308	3,454
CASH AND CASH EQUIVALENTS - Ending	$ 7,921	$ 3,949
SUPPLEMENTAL CASH FLOW INFORMATION		
Interest paid, net	$ 17	$ 45
Income taxes paid	$ 258	$ 184
Surrender of Common Shares	5	3

See accompanying notes to condensed consolidated financial statements.

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NAPCO SECURITY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2018

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

Nature of Business:

Napco Security Technologies, Inc. and Subsidiaries (the "Company" or “Napco”) is a diversified manufacturer 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. 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 Napco's products want to install its products prior to the summer; therefore sales of its products historically peak in the period April 1 through June 30, the Company's fiscal fourth quarter, and are reduced in the period July 1 through September 30, the Company's fiscal first quarter. In addition, demand is affected by the housing and construction markets. Deterioration of the current economic conditions may also affect this trend.

Significant Accounting Policies:

Principles of Consolidation

The unaudited condensed consolidated financial statements of the Company, including these notes, have been prepared by the Company in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and pursuant to the rules and regulations promulgated by the U.S. Securities and Exchange Commission (the “SEC”). Accordingly, certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been omitted or condensed. However, in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. These unaudited condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements for the year ended June 30, 2018 and the notes thereto included in the Company’s Annual Report on Form 10-K filed with the SEC on September 13, 2018. Results of consolidated operations for the interim periods are not necessarily indicative of a full year’s operating results. The unaudited condensed consolidated financial statements 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.

Reclassification

Amounts previously recorded in cost of sales totaling $1,639,000 and 3,246,000 for the three and six months ending December 31, 2017, respectively, have been reclassified to research and development from cost of sales to conform with the current period presentation.

Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent gains and losses at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Critical estimates include management's judgments associated with reserves for sales returns and allowances, concentration of credit risk, inventory reserves, intangible assets and income taxes. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The methods and assumptions used to estimate the fair value of the following classes of financial instruments were: Current Assets and Current Liabilities - The carrying amount of cash and cash equivalents, certificates of deposits, current receivables and payables and certain other short-term financial instruments approximate their fair value as of December 31, 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 December 31, 2018 and June 30, 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 December 31, 2018 and June 30, 2018. The Company has historically not experienced any credit losses with balances in excess of FDIC limits.

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Accounts Receivable

Accounts receivable is stated net of the reserves for doubtful accounts of $182,000 and $195,000 as of December 31, 2018 and June 30, 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 market value, based on various product sales projections. This reserve is calculated using an estimated obsolescence percentage applied to the inventory based on age, historical trends, requirements to support forecasted sales, and the ability to find alternate applications of its raw materials and to convert finished product into alternate versions of the same product to better match customer demand. In addition, and as necessary, the Company may establish specific reserves for future known or anticipated events. There is inherent professional judgment and subjectivity made by both production and engineering members of management in determining the estimated obsolescence percentage.

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

Property, Plant, and Equipment

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

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

Intangible Assets

Intangible assets determined to have indefinite lives are not amortized but are tested for impairment at least annually. Intangible assets with definite lives are amortized over their useful lives. 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):

	December 31, 2018			June 30, 2018		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Customer relationships	$9,800	$ (8,312)	$ 1,488	$9,800	$ (8,155)	$ 1,645
Trade name	5,900	—	5,900	5,900	—	5,900
	$15,700	$ (8,312)	$ 7,388	$15,700	$ (8,155)	$ 7,545

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Amortization expense for intangible assets subject to amortization was approximately $79,000 and $92,000 for the three months ended December 31, 2018 and 2017, respectively. Amortization expense for intangible assets subject to amortization was approximately $157,000 and $185,000 for the six months ended December 31, 2018 and 2017, respectively. Amortization expense for each of the next five fiscal years is estimated to be as follows: 2019 - $313,000; 2020 -$264,000; 2021 - $223,000; 2022 - $188,000; and 2023 - $159,000. The weighted average amortization period for intangible assets was 9.6 years and 10.6 years at December 31, 2018 and 2017, 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 the three months ended December 31, 2018 and 2017 was $435,000 and $462,000, respectively. Advertising expense for the six months ended December 31, 2018 and 2017 was $1,085,000 and $1,103,000, 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 operations. Company-sponsored research and development expense for the three months ended December 31, 2018 and 2017 was $1,762,000 and $1,639,000, respectively. Company-sponsored research and development expense for the six months ended December 31, 2018 and 2017 was $3,507,000 and $3,246,000, respectively. These amounts, previously recorded in cost of sales have been reclassified to research and development to conform with the current period presentation.

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 three months ended December 31 (in thousands, except per share data):

	Net Income		Weighted Average Shares		Net Income per Share	
	2018	2017	2018	2017	2018	2017
Basic EPS	$2,869	$1,233	18,603	18,849	$ 0.15	$ 0.07
Effect of Dilutive Securities:						
Stock Options	—	—	46	34	—	—
Diluted EPS	$2,869	$1,233	18,649	18,883	$ 0.15	$ 0.07

Options to purchase 11,826 and 870 shares of common stock were excluded for the three months ended December 31, 2018 and 2017, respectively were not included in the computation of Diluted EPS because their inclusion would be anti-dilutive. These options were still outstanding at the end of the respective periods.

The following provides a reconciliation of information used in calculating the per share amounts for the six months ended December 31 (in thousands, except per share data):

	Net Income		Weighted Average Shares		Net Income per Share	
	2018	2017	2018	2017	2018	2017
Basic EPS	$4,373	$2,123	18,665	18,848	$ 0.23	$ 0.11
Effect of Dilutive Securities:						
Stock Options	—	—	48	33	—	—
Diluted EPS	$4,373	$2,123	18,713	18,881	$ 0.23	$ 0.11

Options to purchase 5,913 and 435 shares of common stock were excluded for the six months ended December 31, 2018 and 2017, respectively were not included in the computation of Diluted EPS because their inclusion would be anti-dilutive. These options were still outstanding at the end of the respective periods.

Stock-Based Compensation

The Company has established 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 $147,000 and $103,000 were recognized for the three months ended December 31, 2018 and 2017, respectively. Stock-based compensation costs of $152,000 and $136,000 were recognized for the six months ended December 31, 2018 and 2017, 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 three and six months ended December 31, 2018 or 2017.

Comprehensive Income

For the three and six months ended December 31, 2018 and 2017, 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 ($103,000 and $125,000 in the three months ended December 31, 2018 and 2017, respectively and $204,000 and $247,000 in the six months ended December 31, 2018 and 2017, respectively) and classifies the costs associated with these revenues in cost of sales ($265,000 and $252,000 in the three months ended December 31, 2018 and 2017, respectively and $547,000 and $459,000 in the six months ended December 31, 2018 and 2017, respectively).

Recently Issued and Adopted Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 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. The Company is currently evaluating the timing, impact and method of applying this guidance on its consolidated financial statements.

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 $720,000 (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.

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 $2,964,000 as of December 31, 2018. Further, amounts related to promotion payments to customers are now classified as a reduction of sales.

The impact of applying this ASU for the three and six months ended December 31, 2018 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 5% and 8% for the three months ended December 31, 2018 and 2017, respectively. As a percentage of gross sales, sales returns, rebates and allowances were 7% and 8% for the six months ended December 31, 2018 and 2017, 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):

	Three months ended December 31,		Six months ended December 31,	
	2018	2017	2018	2017
Major Product Lines:				
Intrusion and Access alarm products	$ 7,724	$ 6,633	$ 14,815	$ 13,122
Door locking devices	12,961	11,636	25,460	23,733
Services	4,144	2,843	7,930	5,431
Total Revenues	$ 24,829	$ 21,112	$ 48,205	$ 42,286

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 21% and 22% of the Company's accounts receivable at December 31, 2018 and June 30, 2018, respectively. Sales to this customer comprised 12% and 11% of net sales in the three and six months ended December 31, 2018, respectively. Sales to this customer did not exceed 10% of net sales in either of the three or six months ended December 31, 2017. The Company had another customer with an accounts receivable balance that comprised 12% and 11% of the Company's accounts receivable at December 31, 2018 and June 30, 2018, respectively. Sales to this customer did not exceed 10% of net sales in either of the three or six months ended December 31, 2018 or 2017.

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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 (in thousands):

	December 31, 2018	June 30, 2018
Component parts	$ 18,917	$ 16,495
Work-in-process	5,151	4,491
Finished product	9,115	7,948
	$ 33,183	$ 28,934
Classification of inventories, net of reserves:		
Current	$ 27,116	$ 24,533
Non-current	6,067	4,401
	$ 33,183	$ 28,934

NOTE 5 – Property, Plant and Equipment

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

	December 31, 2018	June 30, 2018	Useful Life in Years
Land	$904	$904	—
Buildings	8,911	8,911	30 to 40
Molds and dies	7,326	7,275	3 to 5
Furniture and fixtures	2,601	2,599	5 to 10
Machinery and equipment	23,444	22,996	7 to 10
Leasehold improvements	1,325	706	Shorter of the lease term or life of asset

	44,511	43,391
Less: accumulated depreciation and amortization	(37,106)	(36,600)
	$7,405	$6,791

Depreciation and amortization expense on property, plant, and equipment was approximately $259,000 and $248,000 for the three months ended December 31, 2018 and 2017, respectively. Depreciation and amortization expense on property, plant, and equipment was approximately $506,000 and $484,000 for the six months ended December 31, 2018 and 2017, respectively.

NOTE 6 - Income Taxes

The provision for income taxes represents Federal, foreign, and state and local income taxes. The effective rate differs from statutory rates due to the effect of state and local income taxes, tax rates in foreign jurisdictions, global intangible low-taxed income (“GILTI”), tax benefit of R&D credits and certain nondeductible expenses. Our effective tax rate will change from quarter to quarter based on recurring and non-recurring factors including, but not limited to, the geographical mix of earnings, enacted tax legislation, and state and local income taxes. In addition, changes in judgment from the evaluation of new information resulting in the recognition, de-recognition or re-measurement of a tax position taken in a prior annual period is recognized separately in the quarter of the change.

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. Accounting Standard codification (“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 December 31, 2018, 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 liability was equal to the $381,000 provisional expense reported in the fiscal year ended 6/30/2018.

For the six months ended December 31, 2018, the Company recognized a net income tax expense of $667,000. During the six months ended December 31, 2018, the Company increased its reserve for uncertain income tax positions by $35,000. 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 December 31, 2018, the Company had accrued interest totaling $0 and $256,000 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.

The Company does not expect that our unrecognized tax benefits will significantly change within the next twelve months. We file a consolidated U.S. income tax return and tax returns in certain state and local and foreign jurisdictions. As of December 31, 2018 we remain subject to examination in all tax jurisdictions for all relevant jurisdictional statutes for fiscal years 2015 and thereafter.

In November 2018, the Company received a Notice of Proposed Adjustment ("NOPA") from the Internal Revenue Service (IRS) proposing an adjustment to income for the fiscal 2016 tax year regarding deemed dividends based on its interpretation under IRC Section 956 arising from the intercompany balances on the books of the Company. The incremental tax liability associated with the income adjustment proposed in the NOPA would be approximately $1.8 million, excluding any interest and penalties. The Company strongly believes that the position of the IRS with regard to this matter is inconsistent with the provisions of the 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 Company has identified its U.S. Federal income tax return and its State return in New York as its major tax jurisdictions.

NOTE 7 - Long-Term Debt

As of December 31, 2018, long-term debt consisted of a revolving line of credit of $11,000,000 (“Agreement”) which expires in June 2021.

There were no outstanding borrowings under the revolving line of credit at either December 31, 2018 or June 30, 2018.

The Agreement 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. The Company recorded non-cash compensation expense relating to stock-based compensation of $147,000 and $103,000 for the three months ended December 31, 2018 and 2017, respectively ($0.00 per basic and diluted share for each period) and $152,000 and $136,000 for the six months ended December 31, 2018 and 2017, respectively ($0.00 per basic and diluted share for each period)

2012 Employee Stock Option Plan

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

Under the 2012 Employee Plan, stock options may be granted to valued employees with a term of up to 10 years at an exercise price equal to or greater than the fair market value on the date of grant and are exercisable, in whole or in part, at 20% per year beginning on the date of grant. An option granted under this plan shall vest in full upon a "change in control" as defined in the plan. At December 31, 2018, 71,700 stock options were granted and outstanding, 36,500 stock options were exercisable and 797,900 stock options were available for grant under this plan.

The fair value of each option granted during the six months ended December 31, 2018 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2018	
Risk-free interest rates	3.1	%
Expected lives	10 years	
Expected volatility	52	%
Expected dividend yields	0	%

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

	2018		2017	
	Options	Weighted average exercise price	Options	Weighted average exercise price
Outstanding, beginning of year	57,200	$ 7.09	70,600	$ 5.84
Granted	24,000	15.28	20,000	8.97
Terminated/Lapsed	—	—	—	—
Exercised	(9,500)	5.97	(2,500)	6.31
Outstanding, end of period	71,700	$ 9.98	88,100	$ 6.53
Exercisable, end of period	36,500	$ 7.84	60,300	$ 6.03
Weighted average fair value at grant date of options granted	$8.76		$5.54	
Total intrinsic value of options exercised	$104,000		$7,000	
Total intrinsic value of options outstanding	$417,000		$279,000	
Total intrinsic value of options exercisable	$290,000		$221,000	

9,500 and 2,500 stock options were exercised during the six months ended December 31, 2018 and 2017, respectively. $24,000 and $16,000 of cash was received from option exercises during the six months ended December 31, 2018 and

2017, respectively, and the actual tax benefit realized for the tax deductions from option exercises was $13,000 and $0, respectively.

The following table summarizes information about stock options outstanding under the 2012 Employee Plan at December 31, 2018:

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
$4.29-$16.16	71,700	7.9	$ 9.98	36,500	$ 7.84
	71,700	7.9	$ 9.98	36,500	$ 7.84

As of December 31, 2018, there was $262,000 of unearned stock-based compensation cost related to share-based compensation arrangements granted under the 2012 Employee Plan. 24,000 and 20,000 options were granted during the six months ended December 31, 2018 and 2017, respectively. The total fair value of the options vesting during the three months ended December 31, 2018 and 2017 under this plan was $26,000 and $80,000, respectively. The total fair value of the options vesting during the six months ended December 31, 2018 and 2017 under this plan was $39,000 and $80,000, respectively.

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2012 Non-Employee Stock Option Plan

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

Under the 2012 Non-Employee Plan, stock options may be granted with a term of up to 10 years at an exercise price equal to or greater than the fair market value on the date of grant and are exercisable in whole or in part at 20% per year beginning on the date of grant. An option granted under this plan shall vest in full upon a "change in control" as defined in the plan. At December 31, 2018, 27,800 stock options were granted, 13,800 stock options were exercisable and no further stock options were available for grant under this plan.

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

	2018		2017	
	Options	Weighted average exercise price	Options	Weighted average exercise price
Outstanding, beginning of year	27,800	$ 6.85	14,200	$ 4.69
Granted	—	—	15,000	8.70
Terminated/Lapsed	—	—	—	—
Exercised	11,000	5.36	—	—
Outstanding, end of period	16,800	$ 7.83	29,200	$ 6.75
Exercisable, end of period	7,800	$ 6.83	15,200	$ 5.53
Weighted average fair value at grant date of options granted	n/a		$5.55	
Total intrinsic value of options exercised	$120,000		n/a	
Total intrinsic value of options outstanding	$133,000		$86,000	
Total intrinsic value of options exercisable	$70,000		$63,000	

11,000 and 0 stock options were exercised during the six months ended December 31, 2018 and 2017, respectively. No cash was received from option exercises during either of the six months ended December 31, 2018 or 2017 and the actual tax benefit realized for the tax deductions from option exercises was $28,000 and $0, respectively.

The following table summarizes information about stock options outstanding under the 2012 Non-Employee Plan at December 31, 2018:

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$4.37 - \$8.70	16,800	8.1	\$ 7.83	7,800	\$ 6.83
	16,800	8.1	\$ 7.83	7,800	\$ 6.83

As of December 31, 2018, 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 six months ended December 31, 2018 and 2017, respectively. The total fair value of the options vesting during each of the three months ended December 31, 2018 and 2017 under this plan was \$22,000. The total fair value of the options vesting during the six months ended December 31, 2018 and 2017 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 December 31, 2018, 20,000 stock options were granted, 4,000 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 six months ended December 31, 2018 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2018	
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 Non-Employee Plan for the six months ended December 31,:

	2018			2017		
	Options	Weighted average exercise price		Options	Weighted average exercise price	
Outstanding, beginning of year	—	$	—	—	$	—
Granted	20,000		16.20	—		—
Terminated/Lapsed	—		—	—		—
Exercised	—		—	—		—
Outstanding, end of period	20,000	$	16.20	—	$	—
Exercisable, end of period	4,000	$	16.20	—	$	—