NAPCO SECURITY SYSTEMS INC
Form 10-Q
May 10, 2006

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED: MARCH 31, 2006

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM __________ TO __________.

Commission File number: 0-10004

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

Delaware (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)

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

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

Yes X No ___

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

Large Accelerated Filer ___ Accelerated Filer ___ Non-Accelerated Filer X

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

Yes ___ No X

Number of shares outstanding of each of the issuer's classes of common stock, as of: MAY 8, 2006

COMMON STOCK, $.01 PAR VALUE PER SHARE 13,300,185

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PART I: FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

	March 31, 2006 (unaudited)	June 30, 2005
	(in thousands, except share	

		data)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 988	$ 1,178
Accounts receivable, less allowance for doubtful accounts	20,729	21,899
Inventories, net	23,115	16,242
Prepaid expenses and other current assets	953	799
Deferred income taxes	1,567	1,356
Total current assets	47,352	41,474
Property, Plant and Equipment, net	9,186	8,533
Goodwill	9,686	9,686
Other assets	145	214
	$66,369	$59,907
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 5,758	$ 5,249
Accrued expenses	1,150	1,156
Accrued salaries and wages	2,077	2,518
Accrued income taxes	1,315	1,534
Total current liabilities	10,300	10,457
Long-term debt	3,700	1,950
Accrued income taxes	2,243	2,243
Deferred income taxes	1,707	1,579
Total liabilities	17,950	16,229
Stockholders' Equity (Note 1):		
Common stock, par value $.01 per share; 40,000,000 and 21,000,000 shares authorized, 13,300,185 and 12,982,665 shares issued and outstanding, respectively	133	130
Additional paid-in capital	13,280	11,585
Unearned stock-based compensation	(730)	--
Retained earnings	35,736	31,963
Total stockholders' equity	48,419	43,678
	$66,369	$59,907

* The 3:2 stock split declared on November 29, 2005 (see Note 1) has been retroactively reflected in Stockholders' Equity.

See accompanying notes to condensed consolidated financial statements.

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

Three Months Ended

	March 31, 2006	March 31, 2005
	(in thousands, except share and per share data)	
Net Sales	$ 17,085	$ 15,743
Cost of Sales	10,729	10,647
Gross profit	6,356	5,096
Selling, General and Administrative Expenses	4,032	3,423
Operating income	2,324	1,673
Interest Expense, net	68	50
Other Expenses, net	4	72
Other expenses	72	122
Income before minority interest and provision for income taxes	2,252	1,551
Minority interest in net income of subsidiary, net	2	--
Income before provision for income taxes	2,250	1,551
Provision for income taxes	775	538
Net income	$ 1,475	$ 1,013
Net income per share (Note 1 and Note 4) *: Basic	$ 0.11	$ 0.08
Diluted	$ 0.11	$ 0.07
Weighted average number of shares outstanding (Note 1 and Note 4) *: Basic	13,245,385	12,865,689
Diluted	13,807,626	13,583,310

* The 3:2 stock split declared on November 29, 2005 (see Note 1) has been retroactively reflected in all 2005 share and per share data.

See accompanying notes to condensed consolidated financial statements.

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NAPCO SECURITY SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF INCOME (UNAUDITED)

	Nine Months Ended March 31, 2006	Nine Months Ended March 31, 2005
	(in thousands, except share and per share data)	

Net Sales	$ 48,488	$ 45,202
Cost of Sales	30,958	30,915
Gross profit	17,530	14,287
Selling, General and Administrative Expenses	11,690	10,263
Operating income	5,840	4,024
Interest Expense, net	166	176
Other Expenses, net	10	170
Other expenses	176	346
Income before minority interest and provision for income taxes	5,664	3,678
Minority interest in net loss of subsidiary, net	113	--
Income before provision for income taxes	5,777	3,678
Provision for income taxes	2,004	1,280
Net income	$ 3,773	$ 2,398
Net income per share (Note 1 and Note 4) *: Basic	$ 0.29	$ 0.19
Diluted	$ 0.27	$ 0.18
Weighted average number of shares outstanding (Note 1 and Note 4) *: Basic	13,153,431	12,804,585
Diluted	13,720,926	13,463,438

* The 3:2 stock split declared on November 29, 2005 (see Note 1) has been retroactively reflected in all 2005 share and per share data.

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended March 31,	
	2006	2005
	(in thousands)	
Cash Flows from Operating Activities:		
Net income	$ 3,773	$ 2,398
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	811	844
Provision for doubtful accounts	105	(35)
Deferred income taxes	(83)	--

Excess tax benefits from exercise of stock options	(210)	--
Non-cash stock based compensation expense	312	--
Changes in operating assets and liabilities:		
Accounts receivable	1,065	2,375
Inventories	(6,873)	(638)
Prepaid expenses and other current assets	(154)	(81)
Other assets	65	(42)
Accounts payable, accrued expenses, accrued salaries and wages, and accrued income taxes	53	1,255
Net Cash (Used in) Provided by Operating Activities	(1,136)	6,076
Cash Flows used in Investing Activities:		
Purchases of property, plant and equipment	(1,461)	(548)
Cash Flows from Financing Activities:		
Proceeds from exercise of employee stock options	447	216
Proceeds from long-term debt	1,750	2,350
Principal payments on long-term debt	--	(7,737)
Excess tax benefits from exercise of stock options	210	--
Net cash provided by (used in) financing activities	2,407	(5,171)
Net (decrease) increase in Cash	(190)	357
Cash, Beginning of Period	1,178	796
Cash, End of Period	$ 988	$ 1,153
Cash Paid During the Period for:		
Interest	$ 146	$ 177
Income taxes	$ 2,096	$ 784

See accompanying notes to condensed consolidated financial statements.

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

1.) Summary of Significant Accounting Policies and Other Disclosures

The accompanying Condensed Consolidated Financial Statements are unaudited. In management's opinion, all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation have been made. The results of operations for the period ended March 31, 2006 are not necessarily indicative of results that may be expected for any other interim period or for the full year. Certain prior year amounts have been reclassified to conform with the current years' presentation.

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

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

The unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended June 30, 2005. The accounting policies used in preparing these unaudited Condensed Consolidated Financial Statements are consistent with those described in the June 30, 2005 Consolidated Financial Statements, except as described herein (see Note 2). However, for interim financial statements, inventories are calculated using a gross profit percentage.

Advertising and Promotional Costs

Advertising and promotional costs are included in "Selling, General and Administrative" expenses in the Condensed Consolidated Statements of Income and are expensed as incurred. Advertising expense for the three months ended March 31, 2006 and 2005 was $180,000 and $163,000, respectively. Advertising expense for the nine months ended March 31, 2006 and 2005 was $772,000 and $786,000, respectively.

Research and Development Costs

Research and development costs incurred by the Company are charged to expense in the period incurred. Research and Development expense for the three months ended March 31, 2006 and 2005 was $1,286,000 and $1,222,000, respectively. Research and Development expense for the nine months ended March 31, 2006 and 2005 was $3,690,000 and $3,692,000, respectively. These expenses are included in "Cost of Sales" in the Condensed Consolidated Statements of Income.

Business Concentration and Credit Risk

An entity is more vulnerable to concentrations of credit risk if it is exposed to risk of loss greater than it would have had if it mitigated its risk through diversification of customers. Such risks of loss manifest differently, depending on the nature of the concentration, and vary in significance. The Company has two major customers with Sales and Accounts Receivable as follows (in thousands):

	Sales for the three months ended March 31,			
	2006		2005	
	$	%	$	%
Customer A	1,402	8%	1,353	8%
Customer B	1,190	7%	1,374	9%
	2,592	15%	2,727	17%

	Sales for the nine months ended March 31,			
	2006		2005	
	$	%	$	%
Customer A	3,964	8%	3,452	7%
Customer B	3,617	8%	3,945	9%
	7,581	16%	7,397	16%

Accounts Receivable as of:

	March 31, 2006		June 30, 2005	
	$	%	$	%
Customer A	4,820	23%	4,400	20%
Customer B	2,657	13%	3,306	15%
	7,477	36%	7,706	35%

These customers sell primarily within North America. Although management believes that these customers are sound and creditworthy, a severe adverse impact on their business operations could have a corresponding material adverse effect on the Company's net sales, cash flows, and/or financial condition. In the ordinary course of business, the Company has established an allowance for doubtful accounts and customer deductions in the amount of $485,000 and $380,000 as of March 31, 2006 and June 30, 2005, respectively. The increase in this allowance related primarily to a bankruptcy of one of the Company's customers. The allowance for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This allowance is based upon the evaluation of accounts receivable aging, specific exposures and historical trends.

Stock Options

During the three and nine months ended March 31, 2006 the Company granted 25,000 and 70,000 stock options, respectively, under its 2002 Employee Incentive Stock Option Plan. The aggregate fair value of these options, calculated using the Black-Scholes option pricing model, was $262,000 and $546,000, respectively, which will be expensed over the four year vesting schedule. 108,000 and 317,520 options were exercised under this plan during the three and nine months ended March 31, 2006, respectively. These figures reflect the effect of the 3:2 stock split described below.

Stock Dividend and Stock Splits

On November 29, 2005 the Company's Board of Directors approved a 3-for-2 split of its common stock, payable in the form of a 50% stock dividend to stockholders of record on December 14, 2005. The additional shares were distributed on December 28, 2005. Upon completion of the split, the total number of shares of common stock outstanding increased from approximately 8,795,000 to approximately 13,192,000. There was no net effect on total stockholders' equity as a result of the stock split. All share and per share amounts have been retroactively adjusted to reflect the stock dividend and stock splits.

Recent Accounting Pronouncements

In September 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") No. FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)," to defer the requirement of SFAS No. 123(R) that a freestanding financial instrument originally subject to SFAS No. 123(R) becomes subject to the recognition and measurement requirements of other applicable GAAP when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity. The rights under stock-based payment awards issued to employees by the Company are all dependent on the recipient being an employee of the Company. Therefore, this FSP currently does not have an impact on the Company's consolidated financial statements and its measurement of stock-based compensation in accordance with SFAS No. 123(R).

In October 2005, the FASB issued FSP No. FAS 123(R)-2, "Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)," to provide guidance on determining the grant date for an award as defined in SFAS No. 123(R). This FSP stipulates that assuming all other criteria in the grant date definition are met, a mutual understanding of the key terms and conditions of an award to an individual employee is presumed to exist upon the award's approval in accordance with the relevant corporate governance requirements, provided that the key terms and conditions of an award (a) cannot be negotiated by the recipient with the employer because the award is a unilateral grant, and (b) are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. The Company has applied the principles set forth in this FSP upon its adoption of SFAS No. 123(R).

In November 2005, the FASB issued FSP No. FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards", to provide an alternate transition method for the implementation of SFAS No. 123(R). Because some entities do not have, and may not be able to re-create, information about the net excess tax benefits that would have qualified as such had those entities adopted SFAS No. 123(R) for recognition purposes, this FSP provides an elective alternative transition method. That method comprises (a) a computational component that establishes a beginning balance of the APIC pool related to employee compensation and (b) a simplified method to determine the subsequent impact on the APIC pool of employee awards that are fully vested and outstanding upon the adoption of SFAS No. 123(R). The Company has applied the alternative transition method set forth in this FSP upon its adoption of SFAS No. 123(R).

In February 2006, the FASB issued FSP No. FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event", to address the classification of options and similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of a contingent event. The guidance in this FSP amends paragraphs 32 and A229 of FASB Statement No. 123 (revised 2004), "Share-Based Payment". The Company has applied the principles set forth in this FSP upon its adoption of SFAS No. 123(R).

2.) Employee Stock-based Compensation

The Company has established two share incentive programs as discussed in more detail in the Company's annual report on Form 10-K for the year ended June 30, 2005. Prior to fiscal 2006, the Company applied the intrinsic value method as outlined in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("APB No. 25") and related interpretations in accounting for stock options and share units granted under these programs. Under the intrinsic value method, no compensation expense was recognized if the exercise price of the Company's employee stock options equaled the market price of the underlying stock on the date of the grant. Accordingly, no compensation cost was recognized in the accompanying condensed consolidated statements of income prior to fiscal year 2006 on stock options granted to employees, since all options granted under the Company's share incentive programs had an exercise price equal to the market value of the underlying common stock on the date of grant. Stock-based compensation costs of $197,000 and $312,000 were recognized in three and nine months ended March 31, 2006, respectively. The effect on Basic Earnings per share was $0.015 and $0.024 for the three and nine months ended March 31, 2006, respectively. The effect on both Diluted Earnings per share was $0.014 and $0.023 for the three and nine months ended March 31, 2006, respectively.

Effective July 1, 2005, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)"). This statement replaces SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123") and supersedes APB No. 25. SFAS No. 123(R) requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. This statement was adopted using the modified prospective method of application, which requires us to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro-forma disclosures in prior periods. SFAS No. 123(R) also requires that excess tax benefits related to stock option exercises be reflected as financing cash inflows instead of operating cash inflows.

Prior to the Company's adoption of SFAS No. 123(R), SFAS No. 123 required that the Company provide pro forma information regarding net earnings and net earnings per common share as if compensation cost for the Company's stock-based awards had been determined in accordance with the fair value method prescribed therein. The Company had previously adopted the disclosure portion of SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," requiring quarterly SFAS No. 123 pro forma disclosure. The pro forma charge for compensation cost related to stock-based awards granted was recognized over the service period. For stock options, the service period represents the period of time between the date of grant and the date each option becomes exercisable without consideration of acceleration provisions (e.g., retirement, change of control, etc.).

The following table illustrates the effect on net earnings per common share as if the fair value method had been applied to all outstanding awards for the three and nine months ended March 31, 2005:

	Three Months ended March 31, 2005 (in thousands, except per share data)	Nine Months ended March 31, 2005 (in thousands, except per share data)
Net income, as reported	$1,013	$2,398
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(55)	(171)
Pro forma net income	$ 958	$2,227
Earnings per common share (1):		
Basic - as reported	$ 0.08	$ 0.19
Basic - pro forma	$ 0.07	$ 0.17
Diluted - as reported	$ 0.07	$ 0.18
Diluted - pro forma	$ 0.07	$ 0.17

(1) Information reflects stock dividend and stock splits. See Note 1.

3.) Inventories

	March 31, 2006	June 30, 2005
Inventories consist of (in thousands):		
Component parts	$15,366	$10,740
Work-in-process	2,388	1,697
Finished products	5,361	3,805
	$23,115	$16,242

For interim financial statements, inventories are calculated using a gross profit percentage.

4.) Earnings Per Common Share

The Company follows the provisions of SFAS No. 128, "Earnings Per Share". In accordance with SFAS No. 128, earnings per common share amounts ("Basic

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

A reconciliation between the numerators and denominators of the Basic and Diluted EPS computations for earnings is as follows (in thousands except per share data) (Information reflects the stock dividend and stock splits as described in Note 1):

	Three months ended March 31, 2006		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
BASIC EPS			
Net income attributable to common stock	$1,475	13,245	$0.11
EFFECT OF DILUTIVE SECURITIES			
Options	$ --	562	$ --
DILUTED EPS			
Net income attributable to common stock and assumed option exercises	$1,475	13,807	$0.11

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

	Three months ended March 31, 2005		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
BASIC EPS			
Net income attributable to common stock	$1,013	12,866	$ 0.08
EFFECT OF DILUTIVE SECURITIES			
Options	$ --	717	$(0.01)
DILUTED EPS			
Net income attributable to common stock and assumed option exercises	$1,013	13,583	$ 0.07

No options to purchase shares of common stock in the three months ended March 31, 2005 were excluded in the computation of Diluted EPS because no option prices were in excess of the average market price for this period.

	Nine months ended March 31, 2006		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
BASIC EPS			
Net income attributable to common stock	$3,773	13,153	$ 0.29
EFFECT OF DILUTIVE SECURITIES			
Options	$ --	568	$(0.02)
DILUTED EPS			
Net income attributable to common stock and assumed option exercises	$3,773	13,721	$ 0.27

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

	Nine months ended March 31, 2005		
	Net Income (numerator)	Shares (denominator)	Per Share Amounts
BASIC EPS			
Net income attributable to common stock	$2,398	12,805	$ 0.19
EFFECT OF DILUTIVE SECURITIES			
Options	$ --	658	$(0.01)
DILUTED EPS			
Net income attributable to common stock and assumed option exercises	$2,398	13,463	$ 0.18

No options to purchase shares of common stock in the nine months ended March 31, 2005 were excluded in the computation of Diluted EPS because no option prices were in excess of the average market price for this period.

5.) Long Term Debt

In May 2001, the Company amended its secured revolving credit agreement with its primary bank. The Company's borrowing capacity under the amended agreement was increased to $18,000,000. The amended revolving credit agreement is secured by all the accounts receivable, inventory, the Company's headquarters in Amityville, New York, common stock of three of the Company's subsidiaries and certain other assets of Napco Security Systems, Inc. The revolving credit agreement bears interest at either the Prime Rate less 1/4% or an alternate rate based on LIBOR as described in the agreement. The agreement contains various restrictions and covenants including, among others, restrictions on payment of dividends, restrictions on borrowings, restrictions on capital expenditures, the maintenance of minimum amounts of tangible net worth, and compliance with other certain financial ratios, as defined in the agreement. As of March 31, 2006, the Company was not in compliance with one of these covenants for which it has subsequently received the appropriate waiver from its primary bank. In October 2004 the Company renegotiated this secured revolving credit agreement at essentially the same terms and conditions with a new expiration date of September 2008.

6.) Geographical Data

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2006	2005	2006	2005
Sales to external customers (1):				
Domestic	$14,375	$13,045	$41,057	$37,614
Foreign	2,710	2,698	7,431	7,588
Total Net Sales	$17,085	$15,743	$48,488	$45,202

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

7.) Commitments and Contingencies

As previously reported, on or about August 27, 2001, a Complaint was filed against NAPCO Security Group and Alarm Lock Systems, Inc. by Jose Ramirez and Glenda Ramirez in the Supreme Court of State of New York, County of the Bronx. The Complaint sought fifteen million dollars ($15,000,000) in damages on behalf of Mr. Ramirez and two million dollars ($2,000,000) on behalf of Ms. Ramirez. On May 2, 2006, the Company's motion for summary judgment was granted. As a result, the case against the Company was dismissed.

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

Napco Security Systems, Inc.

Management's Discussion and Analysis of Financial Condition and Results of Operations

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

Overview

The Company is a diversified manufacturer of security products, encompassing intrusion and fire alarms, building access control systems and electronic locking devices. These products are used for commercial, residential, institutional, industrial and governmental applications, and are sold worldwide principally to independent distributors, dealers and installers of security equipment. International sales accounted for approximately 16% and 15% of our revenues for fiscal year 2005 and the first nine months of fiscal 2006, respectively.

The Company owns and operates manufacturing facilities in Amityville, New York and the Dominican Republic. A significant portion of our operating costs are fixed, and do not fluctuate with changes in customer demand or utilization of our manufacturing capacity. As product demand rises and factory utilization increases, the fixed costs are spread over increased output, which should improve profit margins. Conversely, when sales decline our fixed costs are spread over reduced levels, thereby decreasing margins.

The security market is characterized by constant incremental innovation in product design and manufacturing technologies. Generally, the Company devotes 7-8% of revenues to research and development (R&D) on an annual basis. Products resulting from our R&D investments in fiscal 2006 did not contribute materially to revenue during that 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

The post September 11th era has generally been characterized by a favorable business climate for suppliers of electronic security products and services. The

Company believes the security equipment market is likely to continue to exhibit healthy growth, particularly in industrial sectors, due to ongoing concerns over the adequacy of security safeguards.

Seasonality

The Company's fiscal year begins on July 1 and ends on June 30. Historically, the end users of Napco's products want to install its products prior to the summer; therefore sales of its products peak in the period April 1 through June 30, the Company's fiscal fourth quarter, and are reduced in the period July 1 through September 30, the Company's fiscal first quarter. To a lesser degree, sales in Europe are also adversely impacted in the Company's first fiscal quarter because of European vacation patterns, i.e., many distributors and installers are closed for the month of August.

Critical Accounting Policies

The Company's consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America which require, in some cases, that certain estimates and assumptions be made that affect the amounts and disclosures reported in the those financial statements and the related accompanying notes. Estimates are based on current facts and circumstances, prior experience and other assumptions believed to be reasonable. Management uses its best judgment in valuing these estimates and may, as warranted, solicit external advice. Actual results could differ from these estimates, assumptions and judgments and these differences could be material. The following critical accounting policies, some of which are impacted significantly by estimates,

assumptions and judgments, affect the Company's consolidated financial statements. Our most critical accounting policies relate to revenue recognition; concentration of credit risk; inventory; goodwill and other intangible assets; and income taxes.

Revenue Recognition

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

Our sales return accrual is a subjective critical estimate that has a direct impact on reported net sales. This accrual is calculated based on a history of gross sales and actual sales returns, as well as management's estimate of anticipated returns and allowances.

Business Concentration and Credit Risk

An entity is more vulnerable to concentrations of credit risk if it is exposed to risk of loss greater than it would have had if it mitigated its risk through diversification of customers. Such risks of loss manifest differently, depending on the nature of the concentration, and vary in significance. The Company has two major customers with Sales and Accounts receivable as follows (in thousands):

	Sales for the three months ended March 31,			
	2006		2005	
	$	%	$	%
Customer A	1,402	8%	1,353	8%
Customer B	1,190	7%	1,374	9%
	2,592	15%	2,727	17%

	Sales for the nine months ended March 31,			
	2006		2005	
	$	%	$	%
Customer A	3,964	8%	3,452	7%
Customer B	3,617	8%	3,945	9%
	7,581	16%	7,397	16%

	Accounts Receivable as of:			
	March 31, 2006		June 30, 2005	
	$	%	$	%
Customer A	4,820	23%	4,400	20%
Customer B	2,657	13%	3,306	15%
	7,477	36%	7,706	35%

These customers sell primarily within North America. Although management believes that these customers are sound and creditworthy, a severe adverse impact on their business operations could have a corresponding material adverse effect on the Company's net sales, cash flows, and/or financial condition. In the ordinary course of business, the Company has established an allowance for doubtful accounts and customer deductions in the amount of $485,000 and $380,000 as of March 31, 2006 and June 30, 2005, respectively. The allowance for doubtful accounts is a subjective critical estimate that has a direct impact on reported net earnings. This allowance is based upon the evaluation of accounts receivable aging, specific exposures and historical trends.

Inventories

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

We also record an inventory obsolescence reserve, which represents the difference between the cost of the inventory and its estimated fair market value, based on various product sales projections. This reserve is calculated using an estimated obsolescence percentage based on age, historical trends and requirements to support forecasted sales. In addition, and as necessary, we may establish specific inventory obsolescence reserves for known or anticipated events. For interim financial statements, inventories are calculated using a gross profit percentage.

Goodwill and Other Intangible Assets

Effective July 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets". These statements established accounting and reporting standards for acquired goodwill and other intangible assets. Specifically, the standards address how acquired intangible assets should be accounted for both at the time of acquisition and after they have been recognized in the financial statements. In accordance with SFAS No. 142, intangible assets, including purchased goodwill, must be evaluated for impairment. Those intangible assets that are classified as goodwill or as other intangibles with indefinite lives are not amortized.

Impairment testing for Goodwill is performed in two steps: (i) the Company determines impairment by comparing the fair value of a reporting unit with its carrying value, and (ii) if there is an impairment, the Company measures the amount of impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. The Company has performed its annual impairment evaluation required by this standard and determined that the goodwill is not impaired.

Income taxes

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

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

The Internal Revenue Service has issued a Revenue Procedure which is inconsistent with the Code exemption described above. The Code is the actual law; a Revenue Procedure is the IRS's interpretation of the law. The Code has a higher level of authority than a Revenue Procedure. Management believes that it has appropriately relied on the guidance in the Code when filing its income tax return. If challenged, the Company believes that the potential liability would range from $0 to $9,450,000. However, the Company also believes there are other mitigating factors that would limit the amount of the potential liability, and as a result, management accrued a liability of $2,243,000 as of June 30, 2002. The Company's tax provision utilizes estimates made by management and as such, is subject to change.

Results of Operations

	Three months ended March 31,			Nine months ended March		
	2006	2005	% Increase/ (decrease)	2006	2005	% Inc (dec
Net sales	$17,085	$15,743	8.5%	$48,488	$45,202	7
Gross profit	6,356	5,096	24.7%	17,530	14,287	22
Gross profit as a % of net sales	37.2%	32.4%	4.8%	36.2%	31.6%	4
Selling, general and administrative	4,032	3,423	17.8%	11,690	10,263	13
Selling, general and administrative as a percentage of net sales	23.6%	21.7%	1.9%	24.1%	22.7%	1
Operating income	2,324	1,673	38.9%	5,840	4,024	45
Interest expense	68	50	36.0%	166	176	(5
Other expense	4	72	(94.4)%	10	170	(94
Minority interest in net income of subsidiary, net	2	--	n/a	113	--	n
Provision for income taxes	775	538	44.1%	2,004	1,280	56
Net income	1,475	1,013	45.6%	3,773	2,398	57

Sales for the three months ended March 31, 2006 increased by approximately 9% to $17,085,000 as compared to $15,743,000 for the same period a year ago. Sales for the nine months ended March 31, 2006 increased by approximately 7% to $48,488,000 as compared to $45,202,000 for the same period a year ago. The increase in sales for the three and nine months was mainly in the Company's intrusion alarm and access control product lines.

The Company's gross profit for the three months ended March 31, 2006 increased by $1,260,000 to $6,356,000 or 37.2% of sales as compared to $5,096,000 or 32.4% of sales for the same period a year ago. The Company's gross profit for the nine months ended March 31, 2006 increased by $3,243,000 to $17,530,000 or 36.2% of sales as compared to $14,287,000 or 31.6% of sales for the same period a year ago. The increase in gross profit was due primarily to the increase in sales which allowed for more fixed overhead absorption. Increased margins also resulted from a reduction in the Company's inventory reserves of approximately $200,000, the Company's previously reported realignment of its burglar alarm product distribution network as well as cost reductions of certain of the Company's raw material costs.

Selling, general and administrative expenses for the three months ended March 31, 2006 increased by $609,000 to $4,032,000, or 23.6% of sales, as compared to $3,423,000, or 21.7% of sales a year ago. Selling, general and administrative expenses for the nine months ended March 31, 2006 increased by $1,427,000 to $11,690,000, or 24.1% of sales, as compared to $10,263,000, or 22.7% of sales a year ago. The increase in dollars and as a percentage of sales for the three and nine months ended March 31, 2006 was due primarily to increased selling activity, an increase in bad debt expense relating to a bankruptcy of one of the Company's customers as well as the recording of non-cash compensation expenses beginning in fiscal 2006 in accordance with FAS123R.

Interest expense, net for the three months ended March 31, 2006 increased by $18,000 to $68,000 as compared to $50,000 for the same period a year ago. Interest expense, net for the nine months ended March 31, 2006 decreased $10,000 to $166,000 as compared to $176,000 for the same period a year ago. The increase in the third quarter of fiscal 2006 resulted primarily from the increase in interest rates as compared to those from the same period a year ago. The slight decrease in first nine months of fiscal 2006 resulted primarily from lower average outstanding borrowings as partially offset by the increase in interest rates during the nine months ended March 31, 2006 as compared to the same period a year ago.

The Company's provision for income taxes for the three months ended March 31, 2006 increased by $237,000 to $775,000 as compared to $538,000 for the same period a year ago. The Company's provision for income taxes for the nine months ended March 31, 2006 increased by $724,000 to $2,004,000 as compared to $1,280,000 for the same period a year ago. The tax provisions are calculated using an estimated effective tax rate of 35%. The increase in provision for income taxes resulted from the increase in Income before income tax, which resulted primarily from the aforementioned increase in net sales and gross profit.

Net income increased by $462,000 to $1,475,000 or $0.11 per share for the three months ended March 31, 2006 as compared to $1,013,000 or $0.08 per share for the same period a year ago. Net income increased by $1,375,000 to $3,773,000 or $0.29 per share

for the nine months ended March 31, 2006 as compared to $2,398,000 or $0.19 per share for the same period a year ago. These increases were primarily due to the aforementioned increases in net sales and gross profit as partially offset by the increases in selling, general and administrative expenses, net of the related increase in provision for income taxes. The effect of the 3-for-2 stock split discussed above has been retroactively reflected in all fiscal 2005 per share data.

Liquidity and Capital Resources

During the nine months ended March 31, 2006 the Company utilized all of its cash generated from operations plus proceeds from its revolving line of credit ($1,750,000) to purchase property, plant and equipment ($1,461,000) and invest in additional inventory ($6,873,000) as discussed below. The Company's management believes that current working capital, cash flows from operations and its revolving credit agreement will be sufficient to fund the Company's operations through at least the next twelve months.

Accounts Receivable at March 31, 2006 decreased $1,170,000 to $20,729,000 as compared to $21,899,000 at June 30, 2005. This decrease is primarily the result of the higher sales volume during the quarter ended June 30, 2005 as compared to the quarter ended March 31, 2006 as well as extended terms granted to certain of the Company's customers during the quarter ended June 30, 2005. Certain of these terms extended beyond March 31, 2006.

Inventory at March 31, 2006 increased by $6,873,000 to $23,115,000 as compared to $16,242,000 at June 30, 2005. This increase was primarily the result of the Company's level-loading its production schedule in anticipation of its historical sales cycle where a larger portion of the Company's sales occur in the latter fiscal quarters as compared to the earlier quarters as well as adding additional models to the Company's existing product lines.

As of March 31, 2006, the Company's credit facility consisted of an $18,000,000 secured revolving credit agreement. In December 2004, the Company utilized a portion of this revolving credit agreement to accelerate repayment of two term loans aggregating $1,658,000 As of March 31, 2006 there was approximately $14,300,000 available under the secured revolving credit facility. This credit facility expires in September 2008.

As of March 31, 2006 the Company had no material commitments for capital expenditures or inventory purchases other than purchase orders issued in the normal course of business.

ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

The Company's principal financial instrument is long-term debt consisting of a revolving credit and term loan facility that provides for interest at a spread above the prime rate. The Company is affected by market risk exposure primarily through the effect of changes in interest rates on amounts payable by the Company under this credit facility. At March 31, 2006 an aggregate amount of approximately $3,700,000 was outstanding under this facility. If these borrowings remained at this quarter-end level for an entire year and the prime rate increased or decreased, respectively, by 1% the Company would pay or save, respectively, an additional $37,000 in interest that year.

From time to time, the Company requires that letters of credit be provided on foreign sales. In addition, a significant number of transactions by the Company are denominated in U.S. dollars. As such, the Company has shifted foreign currency exposure onto many of its foreign customers. As a result, if exchange rates move against foreign customers, the Company could experience difficulty collecting unsecured accounts receivable, the cancellation of existing orders or the loss of future orders. The foregoing could materially adversely affect the Company's business, financial condition and results of operations because approximately 15% of the Company's net sales are derived from foreign customers. In addition, the Company transacts approximately 50% of these foreign sales in British Pounds Sterling, therefore exposing itself to a certain amount of foreign currency risk. Management believes that the amount of this exposure is immaterial. We are also exposed to foreign currency risk relative to the Dominican Peso ("RD$"), the local currency of the Company's production facility in the Dominican Republic. The result of a 10% strengthening in the U.S. dollar to our RD$ expenses would result in an annual decrease in income from operations of approximately $365,000.

ITEM 4: Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management's control objectives.

At the conclusion of the period ended March 31, 2006, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in alerting them in a timely manner to information relating to the Company required to be disclosed in this report.

Our independent registered accounting firm Marcum & Kliegman, LLP ("MK"), informed us and our Audit Committee of the Board of Directors that in connection with their audit of our financial results for the fiscal year ended June 30, 2005, MK had discovered conditions which they deemed to be significant deficiencies, (as defined by standards established by the Public Company Accounting Oversight Board) in our financial statement closing process. A significant deficiency is a control deficiency where there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. The significant deficiencies related to the timely performance of processes and procedures for the period end closing process and its review by internal accounting personnel. Management has informed MK and the Audit Committee that it will increase its staffing relating to the financial statement closing process to more a adequate level to prevent reoccurrences of this deficiency and will continue to monitor the effectiveness of these actions and will make any other changes or take such additional actions as management determines to be appropriate. Management expects this action be be completed before the end of fiscal 2006.

During the third quarter of 2006, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting except as described above. Management does not believe that the above significant deficiencies affected the results of the quarter ended March 31, 2006 or any prior period.

PART II: OTHER INFORMATION

Item 6. Exhibits

31.1 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Richard L. Soloway, Chairman of the Board and President

31.2 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of Kevin S. Buchel, Senior Vice President of Operations and Finance

32.1 Section 1350 Certifications

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

May 9, 2006

NAPCO SECURITY SYSTEMS, INC
(Registrant)

By: /S/ RICHARD L. SOLOWAY

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

By: /S/ KEVIN S. BUCHEL

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