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ESPEY MFG & ELECTRONICS CORP
Form 10QSB
May 10, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-QSB

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

For the Quarterly Period Ended March 31, 2007

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from _____ to _____

Commission File Number I-4383

ESPEY MFG. & ELECTRONICS CORP.

(Exact name of registrant as specified in charter)

NEW YORK

14-1387171

(State of Incorporation) (I.R.S. Employer's Identification No.)

233 Ballston Avenue, Saratoga Springs, New York 12866

(Address of principal executive offices)

Issuer's telephone number, including area code 518-584-4100

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

| Class ----- | Outstanding at May 10, 2007 ----- |
|-----------------------------------|--------------------------------------|
| Common stock, \$.33-1/3 par value | 2,315,693 shares |

Transitional Small Business Disclosure Format YES NO

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Quarterly Report on Form 10-QSB

I N D E X

| PART I | FINANCIAL INFORMATION | PAGE |
|---------|---|------|
| Item 1 | Financial Statements: | |
| | Balance Sheet (Unaudited) - March 31, 2007 | 1 |
| | Statements of Income (Unaudited) - Three and Nine Months Ended March 31, 2007 and 2006 | 2 |
| | Statements of Cash Flows (Unaudited)- Nine Months Ended March 31, 2007 and 2006 | 3 |
| | Notes to Financial Statements (Unaudited) | 4 |
| Item 2 | Management's Discussion and Analysis of Financial Condition and Results of Operations | 8 |
| Item 3 | Controls and Procedures | 11 |
| PART II | OTHER INFORMATION | 12 |
| Item 1 | Legal Proceedings | 12 |
| Item 2 | Unregistered Sales of Equity Securities and Use of Proceeds | 12 |
| Item 3 | Defaults on Senior Securities | 12 |
| Item 4 | Submission of Matters to a Vote of Security Holders | 12 |
| Item 5 | Other Information | 12 |
| Item 6 | Exhibits | 13 |
| | SIGNATURES | 13 |

PART I: FINANCIAL INFORMATION

ESPEY MFG. & ELECTRONICS CORP.

Balance Sheet (Unaudited)

March 31, 2007

March 31,
2007

ASSETS:

| | |
|--------------------------------|--------------|
| Cash and cash equivalents \$ | \$ 8,138,084 |
| Short term investments | 4,224,000 |
| Trade accounts receivable, net | 4,577,044 |
| Other receivables | 3,356 |

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Inventories:

| | |
|--|---------------|
| Raw materials and supplies | 1,804,576 |
| Work-in-process | 1,955,619 |
| Costs relating to contracts in process, net of advance payments of \$140,045 at March 31, 2007 | 7,923,866 |
| | ----- |
| Total inventories | 11,684,061 |
| Deferred income taxes | 174,431 |
| Prepaid expenses and other current assets | 645,667 |
| | ----- |
| Total current assets | 29,446,643 |
| | ----- |
| Property, plant and equipment, net | 2,884,906 |
| | ----- |
| Total assets | \$ 32,331,549 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY:

| | |
|--|---------------|
| Accounts payable | \$ 998,863 |
| Accrued expenses: | |
| Salaries, wages and commissions | 154,630 |
| Vacation | 546,149 |
| ESOP payable | 220,842 |
| Other | 47,135 |
| Payroll and other taxes withheld and accrued | 54,208 |
| Income taxes payable | 116,136 |
| | ----- |
| Total current liabilities | 2,137,963 |
| | ----- |
| Deferred income taxes | 181,248 |
| | ----- |
| Total liabilities | 2,319,211 |
| | ----- |
| Common stock, par value \$.33-1/3 per share. | |
| Authorized 10,000,000 shares; issued 3,029,874 shares on March 31, 2007. Outstanding 2,313,293 (includes 255,417 Unearned ESOP Shares) on March 31, 2007 | 1,009,958 |
| Capital in excess of par value | 12,737,251 |
| Retained earnings | 26,552,825 |
| Less: Unearned ESOP Shares | (3,961,079) |
| Treasury shares, cost of 716,581 shares on March 31, 2007 | (6,326,617) |
| | ----- |
| Total stockholders' equity | 30,012,338 |
| | ----- |
| Total liabilities and stockholders' equity | \$ 32,331,549 |
| | ===== |

See accompanying notes to the financial statements.

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ESPEY MFG. & ELECTRONICS CORP.
 Statements of Income (Unaudited)
 Three and Nine Months Ended March 31, 2007 and 2006

| | Three Months | | Nine Months | |
|---|--------------|--------------|---------------|-----|
| | 2007 | 2006 | 2007 | Mon |
| Net sales | \$ 8,059,695 | \$ 4,677,808 | \$ 20,250,921 | \$ |
| Cost of sales | 6,443,561 | 3,635,543 | 15,979,258 | |
| Gross profit | 1,616,134 | 1,042,265 | 4,271,663 | |
| Selling, general and administrative expenses | 697,740 | 649,101 | 2,137,463 | |
| Operating income | 918,394 | 393,164 | 2,134,200 | |
| Other income (expense) | | | | |
| Interest and dividend income | 151,896 | 121,213 | 447,285 | |
| Other | 9,589 | (213) | 43,939 | |
| | 161,485 | 121,000 | 491,224 | |
| Income before income taxes | 1,079,879 | 514,164 | 2,625,424 | |
| Provision for income taxes | 365,849 | 149,107 | 888,433 | |
| Net income | \$ 714,030 | \$ 365,057 | \$ 1,736,991 | \$ |
| Net income per share: | | | | |
| Basic | \$ 0.35 | \$ 0.18 | \$ 0.85 | \$ |
| Diluted | \$ 0.34 | \$ 0.18 | \$ 0.84 | \$ |
| Weighted average number of shares outstanding: | | | | |
| Basic | 2,053,545 | 2,010,173 | 2,044,839 | |
| Diluted | 2,077,994 | 2,041,443 | 2,069,730 | |
| Dividends per share: | \$ 0.15 | \$ 0.09 | \$ 0.41 | \$ |

As described in note 7, a stock split in the form of a stock dividend of one share of common stock for each share of common stock issued, was paid on December 30, 2005 (all per share and share amounts have been adjusted to reflect this dividend).

See accompanying notes to the financial statements.

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ESPEY MFG. & ELECTRONICS CORP.
 Statements of Cash Flows (Unaudited)
 Nine Months Ended March 31, 2007 and 2006

| | March 31, 2007 | 2006 |
|--|-------------------|-------|
| | ----- | ----- |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 1,736,991 | \$ 85 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Tax effect on stock options | 64,636 | |
| Stock option compensation | 119,856 | |
| Depreciation | 363,833 | 40 |
| ESOP compensation expense | 333,250 | 33 |
| Loss on disposal of assets | 5,404 | 2 |
| Deferred income tax | (54,867) | (5 |
| Changes in assets and liabilities: | | |
| (Increase) Decrease in trade receivable, net | (363,816) | 13 |
| Decrease (Increase) in other receivables | 3,528 | (|
| Decrease (Increase) in inventories | 720,318 | (2,20 |
| Increase in prepaid expenses and other current assets | (91,540) | (35 |
| Increase in accounts payable | 383,277 | 1,35 |
| Increase in accrued salaries, wages and commissions | 26,623 | 3 |
| (Decrease) Increase in other accrued expenses | (4,265) | |
| Increase in vacation accrual | 726 | 1 |
| Increase in payroll and other taxes withheld and accrued | 13,611 | |
| Decrease in income taxes payable | (538,082) | (16 |
| Decrease in ESOP payable | (112,408) | (7 |
| | ----- | ----- |
| Net cash provided by operating activities | 2,607,075 | 31 |
| | ----- | ----- |
| Cash Flows From Investing Activities: | | |
| Unearned ESOP Shares | -- | (4,33 |
| Additions to property, plant and equipment | (371,701) | (36 |
| Proceeds on sale of assets, net | 10 | |
| Purchase of short term investments | (3,648,000) | (5,28 |
| Maturity of short term investments | 3,360,000 | 4,22 |
| | ----- | ----- |
| Net cash used in investing activities | (659,691) | (5,75 |
| | ----- | ----- |
| Cash Flows From Financing Activities: | | |
| Sale of treasury stock | -- | 4,39 |
| Dividends on common stock | (836,111) | (50 |
| Purchase of treasury stock | (298,064) | (67 |
| Proceeds from exercise of stock options | 252,260 | 15 |
| | ----- | ----- |
| Net cash (used in) provided by financing activities | (881,915) | 3,36 |
| | ----- | ----- |
| Increase (Decrease) in cash and cash equivalents | 1,065,469 | (2,07 |
| Cash and cash equivalents, beginning of period | 7,072,615 | 9,80 |
| | ----- | ----- |
| Cash and cash equivalents, end of period | 8,138,084 | 7,72 |
| | ===== | ===== |

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Supplemental disclosures of cash flow information:

| | | |
|-------------------|--------------|-------|
| Income Taxes Paid | \$ 1,417,038 | \$ 59 |
| | ===== | ===== |

Non-cash investing and financing activities:

During the period ended December 31, 2005, the Company effected a stock split in the form of a stock dividend of 1,514,937 common shares, representing one share for each share outstanding and each share held as a treasury share. This resulted in a transfer from retained earnings to common stock of \$504,979.

See accompanying notes to the financial statements.

3

ESPEY MFG. & ELECTRONICS CORP.
Notes to Financial Statements (Unaudited)

Note 1. Basis of Presentation

In the opinion of management the accompanying unaudited financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary for a fair presentation of the results for such periods. The results for any interim period are not necessarily indicative of the results to be expected for the full fiscal year. Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the Company's most recent audited financial statements included in its 2006 Form 10-KSB.

Note 2. Net income per Share

Basic net income per share excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the income of the Company. As Unearned ESOP shares are released or committed-to-be-released the shares become outstanding for earnings-per-share computations.

Note 3. Stock Based Compensation

Prior to July 1, 2006, the Company accounted for its stock-based compensation plan under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB Opinion No. 25") and related interpretations, as permitted by the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure. Accordingly, no stock-based compensation expense was recognized in the Statement of Income for the three and nine months ended March 31, 2006, as all options granted under the Company's stock-based employee compensation plan had an exercise price equal to the market value of the underlying common stock on the date of grant. As permitted by SFAS No. 123, stock-based compensation expense was included as a pro forma disclosure in the Notes to the Company's financial statements for the three and nine months ended March 31, 2006.

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Effective July 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), Share-Based Payment, using the modified prospective transition method. Under that transition method, compensation cost recognized during the three and nine months ended March 31, 2007 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of July 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123. Results for prior periods have not been restated, as allowed for under the modified prospective transition method. No new grants have been awarded since July 1, 2006.

Total stock-based compensation expense recognized in the Statement of Income for the three and nine months ended March 31, 2007, was \$43,836 and \$119,856, respectively, before income taxes. The related total deferred tax benefit was approximately \$3,470 and \$9,462, for the three and nine months ended March 31, 2007, respectively. Prior to the adoption of SFAS No. 123(R), the Company presented all tax benefits for deductions resulting from the exercise of stock options as operating cash flows in the Statements of Cash Flows. SFAS No. 123(R) requires the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options to be classified and reported as both an operating cash outflow and a financing cash inflow on a prospective basis upon adoption.

As of March 31, 2007 there was approximately \$221,866 of unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over a period of 2 years.

The 2000 Stock Option Plan is the Company's only stock option plan. The Board of Directors may grant options to acquire shares of common stock to employees of the Company at the fair market value of the common stock on the date of grant. Generally, options granted have a two year vesting period based on two years of continuous service and have a ten year contractual life. Option grants provide for accelerated vesting if there is a change in control.

4

Shares issued to satisfy option grants are issued from Treasury stock. Options authorized for issuance under the 2000 Stock Option Plan totaled 275,300. As of March 31, 2007, of the options authorized for issuance, 149,400 were granted and are outstanding, 41,000 of which are vested and exercisable. Options available for future grants at March 31, 2007 total 68,400.

SFAS No. 123(R) requires the use of a valuation model to calculate the fair value of stock-based awards. The Company has elected to use the Black-Scholes option valuation model, which incorporates various assumptions including those for volatility, expected life and interest rates.

The table below outlines the weighted average assumptions that the Company used to calculate stock-based employee compensation for the three and nine months ended March 31, 2007:

| | Three Months Ended March 31, 2007 | Nine Months Ended March 31, 2007 |
|---|--------------------------------------|-------------------------------------|
| | ----- | ----- |
| Dividend yield | 2.40% | 2.53% |
| Expected stock price volatility | 22.29% | 21.80% |
| Risk-free interest rate | 4.54% | 4.42% |
| Expected option life (in years) | 5.0 | 5.0 |
| Weighted average fair value per share of options granted during the period | \$3.284 | \$3.284 |

The Company pays dividends quarterly and does plan to pay dividends in the

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foreseeable future. Expected stock price volatility is based on the historical volatility of the Company's stock. The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent term approximating the expected life of the options. The expected option life (in years) represents the estimated period of time until exercise and is based on the safe harbor calculation under SFAS No. 123.

The following table illustrates the effect on net income per share for the three and nine months ended March 31, 2006 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

| | Three Months Ended March 31, 2006 ----- | Nine Months Ended March 31, 2006 ----- |
|---|---|--|
| Net income, as reported | \$ 365,057 | \$ 857,061 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related income taxes | (20,926) | (46,710) |
| Pro forma net income | \$ 344,131 ===== | \$ 810,351 ===== |
| Income per share: | | |
| Basic - as reported | \$.18 | \$.43 |
| Basic - pro forma | \$.17 | \$.40 |
| Diluted - as reported | \$.18 | \$.42 |
| Diluted - pro forma | \$.17 | \$.40 |

The table below outlines the weighted average assumptions as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the three and nine months ended March 31, 2006:

5

| | Three Months Ended March 31, 2006 ----- | Nine Months Ended March 31, 2006 ----- |
|---|---|--|
| Dividend yield | 2.46% | 2.46% |
| Expected stock price volatility | 23.26% | 23.26% |
| Risk-free interest rate | 4.00% | 4.00% |
| Expected option life (in years) | 5.0 | 5.0 |
| Weighted average fair value per share of options granted during the period | -- | \$4.221 |

The following table summarizes stock option activity during the nine months ended March 31, 2007:

| Employee Stock Options Plan | | |
|-----------------------------|---------------------|----------------------------------|
| Number of Shares | Weighted Average | Weighted Average Remaining |

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| | Subject To Option | Exercise Price | Contractual Term |
|-------------------------------|----------------------|-------------------|---------------------|
| Balance at July 1, 2006 | 146,200 | \$14.02 | 8 |
| Granted | 37,800 | 18.29 | 10 |
| Exercised | (25,000) | 10.09 | -- |
| Forfeited or expired | (9,600) | 14.44 | -- |
| Balance at March 31, 2007 | 149,400 | 15.73 | 8 |
| Exercisable at March 31, 2007 | 41,000 | 10.15 | 6 |

The intrinsic value of stock options exercised was \$106,108, during the nine months ended March 31, 2007. The intrinsic value of stock options outstanding and exercisable as of March 31, 2007 was \$389,485.

Note 4. Commitments and Contingencies

The Company at times, enters into standby letters of credit agreements with financial institutions primarily relating to the guarantee of future performance on certain contracts. The Company has no outstanding standby letters of credit agreements at March 31, 2007. As a government contractor, the Company is continually subject to audit by various agencies of the U.S. Government to determine compliance with various procurement laws and regulations. As a result of such audits and as part of normal business operations of the Company, various claims and charges can be asserted against the Company. It is not possible to predict the outcome of such actions. Currently the Company has no claims or assertions against it.

Note 5. Recently Issued Accounting Standards

In July 2006, the FASB issued Interpretation No. ("FIN") 48, Accounting for Uncertainty in Income Taxes--An Interpretation of FASB Statement No. 109, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In particular, this interpretation requires uncertain tax positions to be recognized only if they are "more-likely-than-not" to be upheld based on their technical merits. Additionally, the measurement of the tax position will be based on the largest amount that is determined to have greater than a 50% likelihood of realization upon ultimate settlement. Any resulting cumulative effect of applying the provisions of FIN 48 upon adoption would be reported as an adjustment to the beginning balance of retained earnings and an adjustment to tax liabilities in the period of adoption. FIN 48 will be effective beginning July 1, 2007. The adoption of FIN 48 will not have a material effect on the Company's financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standard ("SFAS") No. 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements, but does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. The Company is currently evaluating the effect of the guidance contained in SFAS 157 and does not expect the implementation to have a material effect on the Company's financial statements.

Note 6. Employee Stock Ownership Plan

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The Company sponsors a leveraged employee stock ownership plan (the "ESOP") that covers all nonunion employees who work 1,000 or more hours per year and are employed on June 30.

The Company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends on unallocated shares received by the ESOP. All dividends on unallocated shares received by the ESOP are used to pay debt service. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings. As the debt is repaid, shares are released and allocated to active employees, based on the proportion of debt service paid in the year. The Company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the shares purchased by the ESOP are reported as Unearned ESOP Shares in the statement of financial position. As shares are released or committed-to-be-released, the Company reports compensation expense equal to the current average market price of the shares, and the shares become outstanding for earnings-per-share (EPS) computations. ESOP compensation expense was \$114,625 for the quarter ended March 31, 2007 and \$333,250 for the nine-month period ending March 31, 2007. The ESOP shares as of March 31, 2007 were as follows:

| | |
|---|-------------|
| Allocated Shares | 426,296 |
| Committed-to-be-released shares | 18,750 |
| Unreleased shares | 255,417 |
| | ----- |
| Total shares held by the ESOP | 700,463 |
| | ===== |
| Fair value of unreleased shares at March 31, 2007 | \$5,018,944 |
| | ===== |

Note 7. Stock Split

On December 30, 2005, the Company effected a one-for-one stock split in the form of a dividend of one share of common stock for each share of common stock outstanding. The Company also allocated to treasury an additional share for each share being held as a treasury share. All references to the number of common shares, shares related to the Company's stock option plan, as well as per share data in the accompanying financial statements, have been adjusted to reflect the stock split on a retroactive basis. As a result of the stock split, common stock was increased and retained earnings was decreased by \$504,979.

7

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

Overview

Espey Mfg. & Electronics Corp. (the "Company") located in Saratoga Springs, New York, is engaged principally in the development, design, production and sale of specialized electronic power supplies, a wide variety of transformers and other types of iron-core components, and electronic system components. In some cases, the Company manufactures such products in accordance with pre-developed mechanical and electrical requirements ("build to print"). In other cases, the Company is responsible for both the overall design and manufacture of the product. The Company does not generally manufacture standardized components and does not have a product line. The products manufactured by the Company find application principally in (i) shipboard and land based radar, (ii) locomotives,

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(iii) aircraft, (iv) short and medium range communication systems, (v) navigation systems, and (vi) land-based military vehicles.

Business is solicited from large industrial manufacturers and defense companies, the government of the United States, foreign governments and major foreign electronic equipment companies. In certain countries the Company has external sales representatives to help solicit and coordinate foreign contracts. The Company is also on the eligible list of contractors of the United States Department of Defense and generally is automatically solicited by such agencies for procurement needs falling within the major classes of products produced by the Company. In addition, the Company directly solicits bids from the United States Department of Defense for prime contracts.

There is competition in all classes of products manufactured by the Company from divisions of the largest electronic companies, as well as many small companies. The Company's sales do not represent a significant share of the industry's market for any class of its products. The principal methods of competition for electronic products of both a military and industrial nature include, among other factors, price, product performance, the experience of the particular company and history of its dealings in such products. The Company, as well as other companies engaged in supplying equipment for military use, is subject to various risks, including, without limitation, dependence on United States and foreign government appropriations and program allocations, the competition for available military business, and government termination of orders for convenience.

The sales backlog of approximately \$32.1 million at March 31, 2007 gives the Company a solid base of future sales. Management continues to expect an increase in sales for fiscal 2007 as compared to fiscal 2006. In addition to the backlog, the Company currently has outstanding quotations representing approximately \$39.6 million in the aggregate for both repeat and new programs. New orders received in the first nine months of fiscal 2007 were approximately \$14.7 million compared to approximately \$23.7 in the first nine months of fiscal 2006. These orders include both follow-on production quantities for mature products, and engineering development orders which will enable the Company to utilize its engineering expertise in developing new customer specific products. Some of these products, once developed, will be produced in the Company's manufacturing facility and are expected to provide large production order quantities over several years. These orders are in line with the Company's strategy of being involved in long-term high quantity military and industrial products. Although the sales backlog and new orders booked are down as compared to the same point in fiscal 2006, many potential orders are currently being discussed and negotiated with our customers and management expects to book several orders in the final quarter of the fiscal year. Management is currently in the latter stage of negotiations with its customers on potential orders representing in excess of \$20 million in the aggregate and expects to increase the backlog significantly by June 30, 2007. These new orders should allow the Company to maintain current sales levels for fiscal 2008.

The outstanding quotations encompass various new and previously manufactured power supplies, transformers, and subassemblies. However, there can be no assurance that the Company will acquire any or all of the anticipated orders described above, many of which are subject to allocations of the United States defense spending and factors affecting the defense industry and military procurement generally.

The total backlog for the Company of \$32.1 million at March 31, 2007, down \$9 million as compared to March 31, 2006, represents the estimated remaining sales value of work to be performed under firm contracts and includes orders for military and industrial power supplies, and contracts to manufacture certain customer products in accordance with pre-engineered requirements. The funded portion of this backlog at March 31, 2007 is approximately \$27.8 million. This

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includes items that have been authorized and appropriated by Congress and/or funded by the customer. The unfunded backlog is approximately \$4.3 million and represents firm multi-year orders

8

for which funding has not yet been appropriated by Congress. While there is no guarantee that future budgets and appropriations will provide funding for a given program, management has included in unfunded backlog only those programs that it believes are likely to receive funding. The unfunded backlog at March 31, 2006 was \$8.3 million.

Management, along with the Board of Directors, continues to evaluate the need and use of the Company's working capital. Expectations are that the working capital will be required to fund new orders over the next several quarters, dividend payments, and general operations of the business. Also, the Mergers and Acquisitions Committee of the Board of Directors continues to evaluate potential strategic options on a periodic basis.

Critical Accounting Policies and Estimates

We believe our most critical accounting policies include revenue recognition and estimates to completion.

A significant portion of our business is comprised of development and production contracts. Generally, revenues on long-term fixed-price contracts are recorded on a percentage of completion basis using units of delivery as the measurement basis for progress toward completion.

Percentage of completion accounting requires judgment relative to expected sales, estimating costs and making assumptions related to technical issues and delivery schedule. Contract costs include material, subcontract costs, labor and an allocation of overhead costs. The estimation of cost at completion of a contract is subject to numerous variables involving contract costs and estimates as to the length of time to complete the contract. Given the significance of the estimation processes and judgments described above, it is possible that materially different amounts of expected sales and contract costs could be recorded if different assumptions were used, based on changes in circumstances, in the estimation process. When a change in expected sales value or estimated cost is determined, changes are reflected in current period earnings.

Results of Operations

Net sales for the three months ended March 31, 2007 were \$8,059,695 as compared to \$4,677,808 for the same period in 2006, representing a 72.3% increase. Net sales for the nine months ended March 31, 2007 were \$20,250,921 as compared to \$14,294,465 for the same period in 2006, representing a 41.7% increase. Generally, these increases can be attributed to the contract specific nature of the Company's business. The Company continues to deliver product on its single largest order for power supplies. The increase in sales for the three and nine months ended March 31, 2007 is largely attributable to an increase in shipments to two customers for military and industrial power supplies.

The primary factor in determining gross profit and net income is product mix. The gross profits on mature products and build to print contracts are higher than with respect to the products, which are still in the engineering development stage or in the early stages of production. In any given accounting period the mix of product shipments between higher margin mature programs and less mature programs including loss contracts, has a significant impact on gross profit and net income.

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For the three months ended March 31, 2007 and 2006 gross profits were \$1,616,134 and \$1,042,265, respectively. Gross profit as a percentage of sales was 20.1% and 22.3%, for the three months ended March 31, 2007 and 2006, respectively. For the nine months ended March 31, 2007 and 2006 gross profits were \$4,271,663 and \$2,869,915, respectively. Gross profit as a percentage of sales was 21.1% and 20.1%, for the nine months ended March 31, 2007 and 2006, respectively. Management continues to evaluate the Company's workforce to ensure that production and overall execution of the backlog orders and additional anticipated orders are successfully obtained and executed. Employment of full time equivalents at March 31, 2007 was 181 people compared to 173 people at March 31, 2006.

Selling, general and administrative expenses were \$697,740 for the three months ended March 31, 2007, an increase of \$48,639 compared to the three months ended March 31, 2006. Selling, general and administrative expenses were \$2,137,463 for the nine months ended March 31, 2007, an increase of \$152,203 compared to the nine months ended March 31, 2006. The increase for the three and nine months ended March 31, 2007, is primarily due to employee training and recruitment fees, stock option expense and an increase in selling expenses.

9

Other income for three and nine months ended March 31, 2007 increased as compared to the three and nine months ended March 31, 2006 due to increased interest income on the Company's cash and cash equivalents and short-term investments due to higher interest rates. The Company does not believe that there is a significant risk associated with its investment policy, since at March 31, 2007 all of the investments are primarily represented by short-term liquid investments including certificates of deposit and money market accounts.

The effective income tax rate at March 31, 2007 and 2006 was 33.8% and 29.0%, respectively. The effective tax rate is less than the statutory tax rate mainly due to the foreign exportation benefit the Company receives on its international sales, the Qualified Production Activities benefit, and the benefit derived from the ESOP dividends paid on allocated shares.

Net income for the three months ended March 31, 2007, was \$714,030 or \$.35 and \$.34 per share, basic and diluted, respectively, compared to \$365,057 or \$.18 per share, both basic and diluted, for the three months ended March 31, 2006. Net income for the nine months ended March 31, 2007, was \$1,736,991 or \$.85 and \$.84 per share, basic and diluted, respectively, compared to \$857,061 or \$.43 and \$.42 per share, basic and diluted, respectively, for the nine months ended March 31, 2006. The increase in net income per share was due to higher sales, offset partially by the increase in selling, general and administrative expenses.

Liquidity and Capital Resources

The Company's working capital is an appropriate indicator of the liquidity of its business, and during the past three fiscal years, the Company, when possible, has funded all of its operations with cash flows resulting from operating activities and when necessary from its existing cash and investments. The Company did not borrow any funds during the last three fiscal years. Management has available a \$3,000,000 line of credit to help fund further growth or working capital needs, if necessary, but does not anticipate the need for any borrowed funds in the foreseeable future.

The Company's working capital as of March 31, 2007 was approximately \$27.3 million. During the three months ended March 31, 2007 and 2006 the Company repurchased 10,196 and 0 shares, respectively, of its common stock from the Company's Employee Retirement Plan and Trust ("ESOP"), for a total purchase

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price of \$187,861 and \$0, respectively. During the nine months ended March 31, 2007 and 2006 the Company repurchased 16,269 and 38,746 shares, respectively, of its common stock for a total purchase price of \$298,064 and \$679,808, respectively. Under existing authorizations from the Company's Board of Directors, as of March 31, 2007, management is authorized to purchase an additional \$701,936 of Company stock.

| | Nine Months Ended March 31, | |
|---|-----------------------------|-------------|
| | 2007 | 2006 |
| | ----- | ----- |
| Net cash provided by operating activities | \$2,607,075 | \$ 310,642 |
| Net cash used in investing activities | (659,691) | (5,750,964) |
| Net cash (used in) provided by financing activities | (881,915) | 3,364,039 |

Net cash provided by operating activities fluctuates between periods primarily as a result of differences in net income, the timing of the collection of accounts receivable, purchase of inventory, level of sales and payment of accounts payable. Net cash used in investing activities decreased in the first nine months of fiscal 2007 due to the purchase of short-term investments and the ESOP described in note 6. The decrease in cash provided by financing activities is due primarily to the sale of treasury shares to the ESOP in the first half of fiscal 2007.

The Company currently believes that the cash flow generated from operations and when necessary, from cash and cash equivalents, will be sufficient to meet its long-term funding requirements for the foreseeable future.

During the nine months ended March 31, 2007 and 2006, the Company expended \$371,701 and \$360,464, respectively, for plant improvements and new equipment. The Company has budgeted approximately \$500,000 for new equipment and plant improvements in fiscal 2007 and expects to spend slightly over the budgeted amount. Management presently anticipates that the funds required will be available from current operations.

The Company on occasion, enters into standby letters of credit agreements with financial institutions primarily relating to the guarantee of future performance on certain contracts. Contingent liabilities on outstanding standby letters of credit agreements were \$0 at March 31, 2007.

10

CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This report contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The terms "believe," "anticipate," "intend," "goal," "expect," and similar expressions may identify forward-looking statements. These forward-looking statements represent the Company's current expectations or beliefs concerning future events. The matters covered by these statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those set forth in the forward-looking statements, including the Company's dependence on timely development, introduction and customer acceptance of new products, the impact of competition and price erosion, supply and manufacturing constraints, potential new orders from customers and other risks and uncertainties. The foregoing list should not be construed as exhaustive, and the Company disclaims any obligation

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subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made.

Item 3. Controls and Procedures

(a) The Company's management, with the participation of the Company's chief executive officer and chief financial officer, carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Quarterly Report on Form 10-QSB. Based on such evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

(b) There have been no changes in our internal controls over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

11

PART II: Other Information and Signatures

Item 1. Legal Proceedings

None

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

(a) None

(c) Securities Repurchased

Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan or Program | Maximum (or Approximate) Dollar Value of Shares that May Be Purchased Under the Program |
|------------------------------|---|---------------------------------------|---|--|
| March 1 to March 31, 2007 | 10,196 | \$18.425 | 10,196 | \$701,936 |

(1) Pursuant to a prior Board of Directors authorization, as of March 31, 2007 the Company can repurchase up to \$701,936 of its common stock pursuant to an ongoing plan.

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- Item 3 Defaults on Senior Securities
None
- Item 4. Submission of Matters to a Vote of Security Holders
None
- Item 5. Other Information
None

12

Item 6. Exhibits

(a) Exhibits

- 31.1 Certification of the Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Principal Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

S I G N A T U R E S

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.

ESPEY MFG. & ELECTRONICS CORP.

/s/ Howard Pinsley

Howard Pinsley, President and
Chief Executive Officer

/s/ David O'Neil

David O'Neil, Treasurer and
Principal Financial Officer

May 10, 2007

Date