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ESPEY MFG & ELECTRONICS CORP

Form 10-Q

November 12, 2009

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended September 30, 2009

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number I-4383

ESPEY MFG. & ELECTRONICS CORP.  
-----

(Exact name of registrant as specified in its charter)

NEW YORK  
-----

(State of incorporation)

14-1387171  
-----

(I.R.S. Employer's Identification No.)

233 Ballston Avenue, Saratoga Springs, New York 12866  
-----

(Address of principal executive offices)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company:

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company.  Yes  No

At November 11, 2009, there were 2,335,289 shares outstanding of the registrant's Common stock, \$.33-1/3 par value.

ESPEY MFG. & ELECTRONICS CORP.  
Quarterly Report on Form 10-Q

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## I N D E X

| PART I  | FINANCIAL INFORMATION  | PAGE |
|---------|--|------|
| Item 1  | Financial Statements:  |      |
|         | Balance Sheets -<br>September 30, 2009 (Unaudited) and June 30, 2009                     | 1    |
|         | Statements of Income (Unaudited) -<br>Three Months Ended September 30, 2009 and 2008     | 3    |
|         | Statements of Cash Flows (Unaudited)-<br>Three Months Ended September 30, 2009 and 2008  | 4    |
|         | Notes to Financial Statements (Unaudited)  | 5    |
| Item 2  | Management's Discussion and Analysis of<br>Financial Condition and Results of Operations | 8    |
| Item 3  | Quantitative and Qualitative Disclosures About<br>Market Risk                            | 11   |
| Item 4T | Controls and Procedures  | 11   |
| PART II | OTHER INFORMATION AND SIGNATURES   | 12   |
| Item 1  | Legal Proceedings  | 12   |
| Item 2  | Unregistered Sales of Equity Securities  | 12   |
| Item 3  | Defaults Upon Senior Securities  | 12   |
| Item 4  | Submission of Matters to a Vote of Security Holders                                      | 12   |
| Item 5  | Other Information  | 12   |
| Item 6  | Exhibits   | 12   |
|         | SIGNATURES   | 13   |

### PART I: FINANCIAL INFORMATION

#### ESPEY MFG. & ELECTRONICS CORP.

##### Balance Sheet

September 30, 2009 (Unaudited) and June 30, 2009

|  | September 30,<br>2009 | June 30,<br>2009 |
|--|-----------------------|------------------|
|  | -----                 | -----            |
| ASSETS:  |                       |                  |
| Cash and cash equivalents                              | \$ 3,596,115          | \$ 2,775,311     |
| Short term investments                                 | 7,349,874             | 6,349,874        |
| Trade accounts receivable, net                         | 4,009,318             | 5,133,799        |
| ESOP receivable due to dividends on unallocated shares | 25,528                | 71,059           |
| Other receivables                                      | 9                     | 29               |

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|   |               |              |
|---|---------------|--------------|
| Inventories:  |               |              |
| Raw materials   | 1,352,046     | 1,394,44     |
| Work-in-process   | 1,044,434     | 1,107,88     |
| Costs relating to contracts in process, net of progress payments of \$1,256 at September 30, 2009 and \$60,079 at June 30, 2009 | 10,695,861    | 10,526,88    |
|   | -----         | -----        |
| Total inventories   | 13,092,341    | 13,029,20    |
| Deferred income taxes   | 225,036       | 224,83       |
| Prepaid expenses and other current assets   | 198,672       | 233,07       |
|   | -----         | -----        |
| Total current assets  | 28,496,893    | 27,817,44    |
|   | -----         | -----        |
| Property, plant and equipment, net  | 2,768,568     | 2,738,22     |
| Loan receivable   | 34,209        | 38,67        |
|   | -----         | -----        |
| Total assets  | \$ 31,299,670 | \$ 30,594,34 |
|   | =====         | =====        |

See accompanying notes to the financial statements.

(Continued)

1

ESPEY MFG. & ELECTRONICS CORP.  
Balance Sheet  
September 30, 2009 (Unaudited) and June 30, 2009

|  |    |                       |       |
|--|----|-----------------------|-------|
|  |    | September 30,<br>2009 |       |
|  |    | -----                 | ----- |
| LIABILITIES AND STOCKHOLDERS' EQUITY:        |    |                       |       |
| Accounts payable                             | \$ | 1,098,862             | \$    |
| Accrued expenses:                            |    |                       |       |
| Salaries, wages and commissions              |    | 161,140               |       |
| Vacation                                     |    | 501,489               |       |
| Other  |    | 92,257                |       |
| Payroll and other taxes withheld and accrued |    | 42,286                |       |
| Income taxes payable                         |    | 37,506                |       |
|  |    | -----                 | ----- |
| Total current liabilities                    |    | 1,933,540             |       |
|  |    | -----                 | ----- |
| Deferred income taxes                        |    | 92,006                |       |
|  |    | -----                 | ----- |
| Total liabilities                            |    | 2,025,546             |       |
|  |    | -----                 | ----- |

Common stock, par value \$.33-1/3 per share.

Authorized 10,000,000 shares; issued 3,029,874 shares on September 30, 2009 and June 30, 2009. Outstanding 2,335,289 and 2,314,803 (includes 196,041 and 201,666

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|  |               |       |
|--|---------------|-------|
| Unearned ESOP Shares) on September 30, 2009 and June 30, 2009, respectively  | 1,009,958     |       |
| Capital in excess of par value   | 13,939,481    | 1     |
| Retained earnings  | 24,002,983    | 2     |
|  | 38,952,422    | 3     |
| Less: Unearned ESOP shares   | (2,914,077)   | (     |
| Cost of 694,585 and 715,071 shares of common stock in treasury on September 30, 2009 and June 30, 2009, respectively | (6,764,221)   | (     |
|  | 29,274,124    | 2     |
| Total stockholders' equity   | 29,274,124    | 2     |
|  | \$ 31,299,670 | \$ 3  |
|  | =====         | ===== |

See accompanying notes to the financial statements.

2

### ESPEY MFG. & ELECTRONICS CORP. Statements of Income (Unaudited) Three Months Ended September 30, 2009 and 2008

|  | Three Months          |                       |
|--|-----------------------|-----------------------|
|  | September 30,<br>2009 | September 30,<br>2008 |
| Net sales                                    | \$ 6,874,940          | \$ 6,053,519          |
| Cost of sales                                | 4,816,738             | 4,902,244             |
|  | 2,058,202             | 1,151,275             |
| Gross profit                                 |                       |                       |
| Selling, general and administrative expenses | 752,386               | 678,227               |
|  | 1,305,816             | 473,048               |
| Operating income                             |                       |                       |
| Other income                                 |                       |                       |
| Interest and dividend income                 | 42,639                | 102,915               |
| Other  | 8,102                 | 11,241                |
|  | 50,741                | 114,156               |
| Total other income, net                      |                       |                       |
| Income before income taxes                   | 1,356,557             | 587,204               |
| Provision for income taxes                   | 363,794               | 188,908               |
|  | 992,763               | 398,296               |
| Net income                                   | \$ 992,763            | \$ 398,296            |

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Net income per share:

|         |    |       |    |       |
|---------|----|-------|----|-------|
| Basic   | \$ | 0.47  | \$ | 0.19  |
| Diluted | \$ | 0.47  | \$ | 0.19  |
|         |    | ----- |    | ----- |

Weighted average number of shares outstanding:

|         |           |           |
|---------|-----------|-----------|
| Basic   | 2,116,984 | 2,102,306 |
| Diluted | 2,118,848 | 2,116,039 |
|         | -----     | -----     |

|                      |    |        |    |        |
|----------------------|----|--------|----|--------|
| Dividends per share: | \$ | 0.2250 | \$ | 0.2250 |
|                      |    | =====  |    | =====  |

See accompanying notes to the financial statements.

3

ESPEY MFG. & ELECTRONICS CORP.  
 Statements of Cash Flows (Unaudited)  
 Three Months Ended September 30, 2009 and 2008

|  | September 30,<br>2009 | Septem<br>2008 |
|--|-----------------------|----------------|
|  | -----                 | -----          |
| Cash Flows From Operating Activities:  |                       |                |
| Net income   | \$ 992,763            | \$             |
| Adjustments to reconcile net income to net cash provided<br>by operating activities: |                       |                |
| Excess tax benefits from share-based compensation                                    | 626                   |                |
| Stock-based compensation   | 25,304                |                |
| Depreciation   | 115,348               |                |
| ESOP compensation expense  | 90,899                |                |
| Loss on disposal of assets   | 1,615                 |                |
| Deferred income tax benefit  | (7,448)               |                |
| Changes in assets and liabilities:   |                       |                |
| Decrease (increase) in trade receivable, net   | 1,124,474             | (              |
| Increase in income taxes receivables   | --                    | (              |
| Decrease in other receivables  | 288                   |                |
| Decrease in ESOP receivable due to dividends on unallocated shares                   | 45,525                |                |
| Increase in inventories  | (63,136)              | (              |
| Decrease in prepaid expenses and other current assets                                | 34,400                |                |
| Increase in accounts payable   | 99,341                |                |
| (Decrease) increase in accrued salaries, wages and commissions                       | (58,393)              |                |
| Increase (decrease) in other accrued expenses  | 49,394                |                |
| Decrease in vacation accrual   | (18,583)              |                |
| Decrease in ESOP payable   | (90,899)              |                |
| Increase in payroll and other taxes withheld and accrued                             | 211                   |                |
| Decrease in income taxes payable   | (230,011)             |                |
|  | -----                 | -----          |
| Net cash provided by operating activities  | 2,111,718             |                |
|  | -----                 | -----          |
| Cash Flows From Investing Activities:  |                       |                |

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|  |              |       |
|--|--------------|-------|
| Additions to property, plant and equipment           | (147,308)    |       |
| Proceeds from loan receivable                        | 4,464        |       |
| Purchase of short term investments                   | (3,696,000)  | (4,   |
| Proceeds from maturity of short term investments     | 2,696,000    | 2,    |
|  | -----        | ----- |
| Net cash used in investing activities                | (1,142,844)  | (2,   |
|  | -----        | ----- |
| <br>Cash Flows From Financing Activities:            |              |       |
| Sale of treasury stock                               | 326,752      |       |
| Dividends on common stock                            | (475,456)    | (     |
| Purchase of treasury stock                           | --           |       |
| Proceeds from exercise of stock options              | --           |       |
| Excess tax benefits from share-based compensation    | 626          |       |
|  | -----        | ----- |
| Net cash used in financing activities                | (148,078)    | (     |
|  | -----        | ----- |
| <br>Increase (decrease) in cash and cash equivalents |              |       |
|  | 820,796      | (2,   |
| Cash and cash equivalents, beginning of period       | 2,775,319    | 6,    |
|  | -----        | ----- |
| Cash and cash equivalents, end of period             | \$ 3,596,115 | \$ 4, |
|  | =====        | ===== |
| <br>Supplemental Schedule of Cash Flow Information:  |              |       |
| Income taxes paid                                    | \$ 600,000   | \$    |
|  | =====        | ===== |

See accompanying notes to the financial statements.

4

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

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#### 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. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of assets and liabilities. On an ongoing basis, we evaluate our estimates and judgments, including those related to revenue recognition, inventories, income taxes, and stock-based compensation. Management bases its estimates on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. These financial statements should be read in conjunction with the Company's most recent audited financial statements included in its report on Form 10-K for the year ended June 30, 2009.

#### Note 2. Net Income per Share

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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

The Company follows Statement of Financial Accounting Standards No. 123(R) (FASB ASC 718) in establishing standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, as well as transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that maybe settled by the issuance of those equity instruments. FASB ASC 718 requires that the cost resulting from all share-based payment transactions be recognized in the financial statements based on the fair value of the share-based payment. FASB ASC 718 establishes fair value as the measurement objective in accounting for share-based payment transactions with employees, except for equity instruments held by employee share ownership plans.

Total stock-based compensation expense recognized in the Statement of Income for the three month period ended September 30, 2009 and 2008, was \$25,304 and \$29,083, respectively, before income taxes. The related total deferred tax benefit was approximately \$2,477 for the same periods. FASB ASC 718 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 September 30, 2009, there was approximately \$96,684 of unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over the next 2 years. The total deferred tax benefit related to these awards is approximately \$8,526.

The Company has one employee stock option plan under which options may be granted, the 2007 Stock Option and Restricted Stock Plan (the "2007 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. Shares issued upon the exercise of options are from those held in Treasury. The 2007 Plan was approved by the Company's shareholders at the Company's Annual Meeting on November 30, 2007 and supercedes the Company's 2000 Stock Option Plan (the "2000 Plan"). Options covering 400,000 shares are authorized for issuance under the 2007 Plan, and 68,700 have been granted and are outstanding as of September

5

30, 2009. While no further grants of options may be made under the 2000 Plan, as of September 30, 2009, 76,500 options remain outstanding, vested and exercisable from the 2000 Plan.

FASB ASC 718 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.

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The table below outlines the weighted average assumptions that the Company used to calculate stock-based employee compensation for the three months ended:

|   | September 30,<br>2009<br>----- | September 30,<br>2008<br>----- |
|---|--------------------------------|--------------------------------|
| Dividend yield  | 4.49%                          | 3.34 %                         |
| Expected stock price volatility   | 29.22%                         | 24.41 %                        |
| Risk-free interest rate   | 2.46%                          | 3.91 %                         |
| Expected option life (in years)   | 4 yrs                          | 4 yrs                          |
| Weighted average fair value per share of options<br>granted during the period | \$3.351                        | \$3.594                        |

The Company pays dividends quarterly and anticipates that it will be able to continue to pay dividends in the 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 actual historical experience.

The following table summarizes stock option activity during the three months ended September 30, 2009:

| Employee Stock Options Plan<br>----- |   |  |   |
|--------------------------------------|---|--|---|
|                                      | Number of<br>Shares<br>Subject<br>To Option | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term |
| -----                                |   |  |   |
| Balance at July 1, 2009              | 140,400                                     | \$18.29                                  | 7.65  |
| Granted                              | 2,500                                       | \$17.09                                  | 9.84  |
| Exercised                            | --  | --                                       | --  |
| Forfeited or expired                 | (3,400)                                     | \$19.07                                  | --  |
| -----                                |   |  |   |
| Balance September 30, 2009           | 139,500                                     | \$18.25                                  | 7.69  |
| =====                                |   |  |   |
| Exercisable at September 30, 2009    | 76,500                                      | \$17.41                                  | 6.58  |
| =====                                |   |  |   |

The intrinsic value of stock options exercised was \$0 and \$18,495, during the three months ended September 30, 2009 and 2008, respectively. The intrinsic value of stock options outstanding and exercisable as of September 30, 2009 and 2008 was \$42,948 and \$90,945, respectively.

#### Note 4. Commitments and Contingencies

The Company at certain times 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 aggregated to zero at September 30, 2009. 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.



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Currently the Company has no claims or assertions pending or threatened against it.

### Note 5. Recently Issued Accounting Standards

In May 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard No. 165, Subsequent Events (FASB ASC 855-10). FASB ASC 855-10 establishes principles and requirements for subsequent events.

6

FASB ASC 855-10 is effective for interim or annual financial periods ending after June 15, 2009. As such, the Company is required to adopt this standard in the current period. Adoption of FASB ASC 855-10 did not have a material effect on the company's financial statements.

In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard No. 168 ("SFAS 168"), The FASB Accounting Standards Codification ("Codification") and the Hierarchy of Generally Accepted Accounting Principles - a replacement of FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles. Under the provisions of SFAS 168, the Codification will become the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. The rules and interpretive releases of the SEC under authority federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of SFAS 168, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification will become non-authoritative. The provisions of SFAS 168 are effective for financial statements issued for interim and annual periods ending after September 15, 2009. Adoption of SFAS 168 had no effect on the company's financial statements.

In September 2009, the FASB issued ASC 605-25 for revenue recognition with multiple deliverables. These new standards impact the determination of when the individual deliverables included in a multiple-element arrangement may be treated as separate units of accounting. Additionally, these new standards modify the manner in which the transaction consideration is allocated across the separately identified deliverables by no longer permitting the residual method of allocating arrangement consideration. These new standards are effective in fiscal years beginning on or after June 15, 2010, however early adoption is permitted. The Company is currently assessing the potential impact, if any, of the guidance on its financial statements.

### Note 6. Employee Stock Ownership Plan

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 FASB ASC 718. 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 \$90,899 for the three-month period ended September 30, 2009 and \$118,418 for the three-month period ended September 30, 2008. The ESOP shares as of September 30,

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2009 and 2008 were as follows:

|                                     | September 30,<br>2009 | September 30,<br>2008 |
|-------------------------------------|-----------------------|-----------------------|
|                                     | -----                 | -----                 |
| Allocated Shares                    | 461,537               | 442,886               |
| Committed-to-be-released shares     | 5,625                 | 5,833                 |
| Unreleased shares                   | 196,041               | 219,167               |
|                                     | -----                 | -----                 |
| <br>Total shares held by the ESOP   | <br>663,203           | <br>667,886           |
|                                     | =====                 | =====                 |
| <br>Fair value of unreleased shares | <br>\$ 3,473,847      | <br>\$ 4,021,714      |
|                                     | =====                 | =====                 |

### Note 7. Subsequent Events

Subsequent events were evaluated through November 11, 2009, the dates these financial statements were available for issue.

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

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 agencies 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

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foreign government appropriations and program allocations, the competition for available military business, and government termination of orders for convenience.

New orders received in the first three months of fiscal 2010 were approximately \$4.8 million, representing a 13.1% decrease from the amount of new orders received in the first three months of fiscal 2009. These new orders are in line with the Company's strategy of getting involved in long-term high quantity military and industrial products and are predominately for follow-on production of mature products. The Company's backlog was \$37.0 million at September 30, 2009 which includes \$19.1 million from two significant customers compared to \$44.2 million at September 30, 2008 which included \$28.0 million from two significant customers. The backlog for the Company represents the estimated remaining sales value of work to be performed under firm contracts.

The sales backlog gives the Company a solid base of future sales. Based upon the backlog and the anticipated schedule for the fulfillment of orders, management expects sales for fiscal 2010 to be higher than fiscal 2009 sales. In addition to the backlog, the Company currently has outstanding quotations and potential business representing approximately \$52.1 million in the aggregate for both repeat and new programs.

Net sales to three significant customers represented 66.8% of the Company's total sales for the three month period ended September 30, 2009 and net sales to two significant customers represented 71.8% of the Company's total sales for the first three month period ended September 30, 2008. Historically, a small number of customers have accounted for a large percentage of the Company's total sales in any given fiscal year. For several years, management has pursued opportunities with current and new customers with an overall objective of lowering the concentration of sales, mitigating excessive reliance upon a single major product of a particular program and minimizing the impact of the loss of a single significant customer. Management continues to evaluate its business development functions and potential revised courses of action.

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.

8

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 any increase in 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

Management believes 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

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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 September 30, 2009 were \$6,874,940 as compared to \$6,053,519 for the same period in 2008, representing a 13.6% increase. The increase for the three months ended September 30, 2009 was due to an overall increase in transformer shipments offset by a decrease in power supply shipments.

For the three months ended September 30, 2009 and 2008 gross profits were \$2,058,202 and \$1,151,275, respectively. Gross profit as a percentage of sales was 29.9% and 19.0%, for the three months ended September 30, 2009 and 2008, respectively. 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 as compared to 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. The increased gross profit and gross profit percentage in the three months ended September 30, 2009, as compared to September 30, 2008, was primarily the result of favorable product mix with only minor cost overruns related to loss contracts. For the three months ended September 30, 2008 the Company had unexpected losses incurred on two programs with significant engineering and production time required for design efforts. These two programs experienced significant cost overruns due to extended product qualification testing and difficulties moving the products from engineering design into full production. Currently, one program has completed qualification testing and has moved into full production. The other program is still in qualification and has made significant progress towards completion. 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 September 30, 2009 was 166 compared to 169 people at September 30, 2008.

Selling, general and administrative expenses were \$752,386 for the three months ended September 30, 2009; an increase of \$74,159, compared to the three months ended September 30, 2008. The increase for the three months ended September 30, 2009 relates primarily to an increase in salary expense, consulting, and director fees.

Other income for three months ended September 30, 2009 decreased as compared to the three months ended September 30, 2008 due to decreased interest rates and related interest income on the Company's cash and cash equivalents and short-term investments. The Company does not believe there is a significant risk associated with its investment policy, since at September 30, 2009 all of the investments were primarily represented by short-term liquid investments including certificates of deposit and money market funds.

The effective income tax rate at September 30, 2009 and 2008 was 26.8% and

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32.2%, respectively. The effective tax rate is less than the statutory tax rate mainly due to the benefit the Company receives on its Qualified Production Activities and the benefit derived from the ESOP dividends paid on allocated shares.

Net income for the three months ended September 30, 2009, was \$992,763 or \$.47 per share, both basic and diluted, compared to \$398,296 or \$.19 per share, both basic and diluted, for the three months ended September 30, 2008. The increase in net income per share was mainly due to higher gross profit on sales offset by higher selling general and administrative expenses and decreased interest income.

### Liquidity and Capital Resources

The Company's working capital is an appropriate indicator of the liquidity of its business, and during the past two 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.

The Company's working capital as of September 30, 2009 was approximately \$26.6 million. During the three months ended September 30, 2009 and 2008 the Company repurchased 0 and 2,744 shares, respectively, of its common stock on the open market for a total purchase price of \$0 and \$52,038, respectively. Under existing authorizations from the Company's Board of Directors, as of September 30, 2009, management is authorized to purchase an additional \$1,688,454 million of Company stock.

|   | Three Months Ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2009 | September 30,<br>2008 |
|   | -----                 | -----                 |
| Net cash provided by operating activities | 2,111,718             | \$ 66,023             |
| Net cash used in investing activities     | (1,142,844)           | (2,249,246)           |
| Net cash used in financing activities     | (148,078)             | (428,271)             |

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 three months of fiscal 2010 due to the due to more short-term investments maturing during the current period. The decrease in cash used in financing activities is due primarily to decreased purchase of treasury shares and a decrease in the proceeds from the exercise of stock options.

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 three months ended September 30, 2009 and 2008, the Company expended \$147,308 and \$125,755, respectively, for plant improvements and new equipment. The Company has budgeted approximately \$450,000 for new equipment and plant improvements in fiscal 2010. Management anticipates that the funds required will be available from current operations.

The Company at certain times 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 aggregated to zero at September 30, 2009.

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### 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 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. Quantitative and Qualitative Disclosures About Market Risk

The Company is a smaller reporting company as defined under Securities and Exchange Commission Rule 12b-2. Pursuant to the exemption available to smaller reporting company issuers under Item 305 of Regulation S-K, quantitative and qualitative disclosures about market risk, the Company is not required to provide the information for this item.

#### Item 4T. 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-Q. 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) Securities Sold - For the three-month period ended September 30, 2009, the Company sold 20,486 shares to the ESOP. The aggregate gross proceeds from

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the shares of common stock sold were \$169,009.50. The securities were sold for cash and the sales were made without registration under the Securities Act in reliance upon the exemption from registration afforded under Section 4(2) of the Securities Act of 1933. Proceeds were used for general working capital purposes.

(c) Securities Repurchased - None

Item 3 Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. 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

12

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

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Howard Pinsley  
Chief Executive Officer

/s/ David O'Neil

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David O'Neil, Treasurer and  
Principal Financial Officer

November 11, 2009

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Date