

ESPEY MFG & ELECTRONICS CORP
Form 10-Q
November 09, 2011

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, 2011
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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 7, 2011, there were 2,324,891 shares outstanding of the registrant's Common stock, \$.33-1/3 par value.

ESPEY MFG. & ELECTRONICS CORP.
 Quarterly Report on Form 10-Q
 I N D E X

<u>PART FINANCIAL INFORMATION</u>	PAGE
<u>I</u>	
<u>Item 1</u>	<u>Financial Statements:</u>
	<u>Balance Sheets -</u>
	<u>September 30, 2011 (Unaudited) and June 30, 2011</u>
	1
	<u>Statements of Income (Unaudited) -</u>
	<u>Three Months Ended September 30, 2011 and 2010</u>
	3
	<u>Statements of Cash Flows (Unaudited)-</u>
	<u>Three Months Ended September 30, 2011 and 2010</u>
	4
	<u>Notes to Financial Statements (Unaudited)</u>
	5
<u>Item 2</u>	<u>Management's Discussion and Analysis of</u>
	<u>Financial Condition and Results of Operations</u>
	8
<u>Item 3</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	11
<u>Item 4</u>	<u>Controls and Procedures</u>
	11
<u>PART OTHER INFORMATION AND SIGNATURES</u>	12
<u>II</u>	
<u>Item 1</u>	<u>Legal Proceedings</u>
	12
<u>Item 2</u>	<u>Unregistered Sales of Equity Securities</u>
	12
<u>Item 3</u>	<u>Defaults Upon Senior Securities</u>
	12
<u>Item 4</u>	<u>Submission of Matters to a Vote of Security Holders</u>
	12
<u>Item 5</u>	<u>Other Information</u>
	12
<u>Item 6</u>	<u>Exhibits</u>
	12
<u>SIGNATURES</u>	13

Index

PART I: FINANCIAL INFORMATION

ESPEY MFG. & ELECTRONICS CORP.

Balance Sheets

September 30, 2011 (Unaudited) and June 30, 2011

	2011 September 30,	2011 June 30,
ASSETS:		
Cash and cash equivalents	\$ 10,336,395	\$9,695,811
Investment securities	2,546,502	1,946,214
Trade accounts receivable, net	5,298,866	6,266,765
Income tax receivable	75,875	--
Inventories:		
Raw materials	1,372,158	1,273,582
Work-in-process	1,239,278	1,085,278
Costs relating to contracts in process, net of progress payments of \$27,963 at September 30, 2011 and \$126,361 at June 30, 2011	8,251,765	8,220,200
Total inventories	10,863,201	10,579,060
Deferred income taxes	368,907	360,553
Prepaid expenses and other current assets	148,361	208,904
Total current assets	29,638,107	29,057,307
Property, plant and equipment, net	2,635,057	2,703,014
Loan receivable	98,185	108,303
Total assets	\$ 32,371,349	\$31,868,624

See accompanying notes to the financial statements.

(Continued)

Index

ESPEY MFG. & ELECTRONICS CORP.
Balance Sheets
September 30, 2011 (Unaudited) and June 30, 2011

	2011 September 30,	2011 June 30,
LIABILITIES AND STOCKHOLDERS' EQUITY:		
Accounts payable	\$ 1,613,290	\$1,453,707
Accrued expenses:		
Salaries, wages and commissions	464,384	412,555
Vacation	586,554	623,757
ESOP Payable	92,323	--
Other	70,721	121,026
Payroll and other taxes withheld and accrued	46,724	44,085
Income taxes payable	--	277,746
Total current liabilities	2,873,996	2,932,876
Deferred income taxes	252,763	270,729
Total liabilities	3,126,759	3,203,605
Common stock, par value \$.33-1/3 per share.		
Authorized 10,000,000 shares; Issued 3,029,874 shares on September 30, 2011 and June 30, 2011. Outstanding 2,324,891 and 2,320,960 (includes 152,292 and 157,500 Unearned ESOP Shares) on September 30, 2011 and June 30, 2011, respectively		
	1,009,958	1,009,958
Capital in excess of par value	14,783,420	14,674,189
Accumulated other comprehensive income (loss)	(1,692)	--
Retained earnings	23,219,627	22,780,026
	39,011,313	38,464,173
Less: Unearned ESOP shares	(2,275,872)	(2,275,872)
Treasury shares, cost of 704,983 and 708,914 shares on September 30, 2011 and June 30, 2011, respectively	(7,490,851)	(7,523,282)
Total stockholders' equity	29,244,590	28,665,019
Total liabilities and stockholders' equity	\$ 32,371,349	\$31,868,624

See accompanying notes to the financial statements.

2

Index

ESPEY MFG. & ELECTRONICS CORP.
 Statements of Income (Unaudited)
 Three Months Ended September 30, 2011 and 2010

	Three Months	
	2011	2010
Net sales	\$7,993,927	\$6,026,330
Cost of sales	5,992,119	4,375,798
Gross profit	2,001,808	1,650,532
Selling, general and administrative expenses	742,867	692,709
Operating income	1,258,941	957,823
Other income		
Interest income	10,167	16,824
Other	26,883	75,048
	37,050	91,872
Income before income taxes	1,295,991	1,049,695
Provision for income taxes	369,087	296,156
Net income	\$926,904	\$753,539
Net income per share:		
Basic	\$0.43	\$0.35
Diluted	\$0.42	\$0.35
Weighted average number of shares outstanding:		
Basic	2,164,202	2,141,447
Diluted	2,196,104	2,153,627
Dividends per share:	\$0.2250	\$0.2250

See accompanying notes to the financial statements.

Index

ESPEY MFG. & ELECTRONICS CORP.
 Statements of Cash Flows (Unaudited)
 Three Months Ended September 30, 2011 and 2010

	September 30,	
	2011	2010
Cash Flows From Operating Activities:		
Net income	\$926,904	\$753,539
Adjustments to reconcile net income to net cash provided by operating activities:		
Excess tax benefits from share-based compensation	(39,028)	(4,488)
Stock-based compensation	16,316	16,040
Depreciation	108,248	113,645
ESOP compensation expense	127,761	107,033
Loss on disposal of assets	79	--
Deferred income tax benefit	(26,320)	9,452
Changes in assets and liabilities:		
Decrease in trade receivable, net	967,899	1,458,295
Increase in income taxes receivables	(75,875)	(88,991)
Increase in inventories	(284,141)	(248,205)
Decrease (increase) in prepaid expenses and other current assets	60,543	(49,417)
Increase (decrease) in accounts payable	159,583	(426,338)
Increase in accrued salaries, wages and commissions	51,829	32,038
Decrease in vacation accrual	(37,203)	(34,781)
Decrease in ESOP payable	(35,438)	(40,312)
Decrease in other accrued expenses	(50,305)	(143,458)
Increase (decrease) in payroll and other taxes withheld and accrued	2,639	(4,367)
Decrease in income taxes payable	(238,718)	(10,305)
Net cash provided by operating activities	1,634,773	1,439,380
Cash Flows From Investing Activities:		
Additions to property, plant and equipment	(40,370)	(107,247)
Proceeds from loan receivable	10,118	4,600
Purchase of investment securities	(1,611,980)	(1,778,000)
Maturity of investment securities	1,010,000	4,128,000
Net cash (used in) provided by investing activities	(632,232)	2,247,353
Cash Flows From Financing Activities:		
Sale of treasury stock	58,974	12,081
Dividends on common stock	(487,303)	(481,800)
Proceeds from exercise of stock options	27,344	79,660
Excess tax benefits from share-based compensation	39,028	4,488
Net cash used in financing activities	(361,957)	(385,571)
Increase in cash and cash equivalents	640,584	3,301,162
Cash and cash equivalents, beginning of period	9,695,811	4,475,066
Cash and cash equivalents, end of period	\$10,336,395	\$7,776,228

Supplemental Schedule of Cash Flow Information:

Income taxes paid	\$710,000	\$386,000
-------------------	-----------	-----------

See accompanying notes to the financial statements.

4

Index

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. 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, 2011. Certain reclassifications may have been made to the prior year financial statements to conform to the current year presentation.

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

The Company follows 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 may be settled by the issuance of those equity instruments. 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. 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, 2011 and 2010, was \$16,316 and \$16,040, respectively, before income taxes. The related total deferred tax benefit was approximately \$1,489 and \$1,328 for the same periods. 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, 2011, there was approximately \$153,575 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 \$16,680.

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, of which 128,900 have been granted and 106,300 are outstanding as of September 30, 2011. While no further grants of options may be made under the 2000 Plan, as of September 30, 2011, 53,600 options remain outstanding, vested and exercisable from the 2000 Plan.

Index

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.

The table below outlines the weighted average assumptions that the Company used to calculate the fair value of each option award for the quarter ended:

	September 30, 2011	September 30, 2010
Dividend yield	3.59%	4.69%
Expected stock price volatility	33.82%	33.13%
Risk-free interest rate	0.64%	1.08%
Expected option life (in years)	3.6 yrs	4.1 yrs
Weighted average fair value per share of options granted during the period	\$ 4.757	\$ 3.335

The Company pays dividends quarterly and anticipates that it will be able to continue to pay dividends in the foreseeable future. While the Company has paid a special cash dividend of \$1.00 per share in each of fiscal years 2011 and 2010, there is no assurance that the Board of Directors will declare a comparable special dividend in fiscal year 2012. 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, 2011:

	Employee Stock Options Plan			
	Number of Shares Subject To Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Balance at July 1, 2011	132,400	\$18.62	6.80	
Granted	29,100	\$19.32	9.90	
Exercised	(1,600)	\$17.09	--	
Forfeited or expired	--	--	--	
Outstanding at September 30, 2011	159,900	\$18.76	7.15	\$595,777
Vested or expected to vest at September 30, 2011	151,522	\$18.73	7.03	\$578,108
Exercisable at September 30, 2011	100,200	\$18.46	5.82	\$473,683

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the closing sale price of the Company's common stock as reported on the NYSE-Amex on September 30, 2011 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders if all option holders had exercised their options on September 30, 2011. This amount changes based on the fair market value of the Company's common stock. The total intrinsic values of the options exercised during the three months ended September 30, 2011 and 2010 was \$9,360 and \$3,563, 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, 2011 and 2010. The Company, as a U.S. Government contractor, is subject to audits, reviews, and investigations by the U.S. government related to its negotiation and performance of government contracts and its accounting for such contracts. Failure to comply with applicable U.S. Government standards by a contractor may result in suspension from eligibility for award of any new government contract and a guilty plea or conviction may result in debarment from eligibility for awards. The government may, in certain cases, also terminate existing contracts, recover damages, and impose other sanctions and penalties. As a result of a pending U.S. government audit the Company has determined a range of possible outcomes none of which the Company believes would have a materially adverse effect on the Company's financial position or results of operations. In accordance with ASC 450 "Contingencies" the Company has accrued the amount within the range that appears to be its best estimate of a possible outcome.

Index

Note 5. Recently Issued Accounting Standards

In May 2011, the FASB issued Accounting Standards Update No. 2011-04, topic 820, Fair Value Measurement, to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with United States GAAP and International Financial Reporting Standards. Some of the amendments clarify the Board's intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. Specifically, the guidance requires additional disclosures for fair value measurements that are based on significant unobservable inputs. The updated guidance is to be applied prospectively and is effective for the Company's interim and annual periods beginning January 1, 2012. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

FASB Accounting Standards Update 2011-05, "Presentation of Comprehensive Income," was issued in June 2011 to be effective for fiscal years beginning after December 15, 2011. Comprehensive income includes certain items that are recognized as "other comprehensive income" ("OCI") and are excluded from net income. Examples include unrealized gains/losses on certain investments and gains/losses on derivative instruments designated as hedges. Under provisions of the update, the components of OCI must be presented in one of two formats: either (i) together with net income in a continuous statement of comprehensive income or (ii) in a second statement of comprehensive income to immediately follow the income statement. An existing option to present the components of OCI as part of the statement of changes in shareholders' equity is being eliminated. The Company expects the update to have minimal effect 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 718-40. 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 \$127,761 for the three-month period ended September 30, 2011 and \$107,033 for the three-month period ended September 30, 2010. The ESOP shares as of September 30, 2011 and 2010 were as follows:

	September 30, 2011	September 30, 2010
Allocated Shares	440,023	445,729
Committed-to-be-released shares	5,208	5,417
Unreleased shares	152,292	173,749
Total shares held by the ESOP	597,523	624,895
Fair value of unreleased shares	\$ 3,531,651	\$ 3,752,978

Index

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

Overview

Espey Mfg. & Electronics Corp. (“Espey”) is a power electronics design and original equipment manufacturing (OEM) company with a long history of developing and delivering highly reliable products for use in military and severe environment applications. All design, manufacturing, and testing is performed in our 150,000+ square foot facility located at 233 Ballston Ave, Saratoga Springs, New York. Espey is classified as a “smaller reporting company” for purposes of the reporting requirements under the Securities Exchange Act of 1934, as amended. Espey’s common stock is publicly-traded on the NYSE-Amex under the symbol “ESP.”

Espey began operations after incorporation in New York in 1928. We strive to remain competitive as a leader in high power energy conversion and transformer solutions through the design and manufacture of new and improved products by using advanced and “cutting edge” electronics technologies.

Espey is ISO 9001:2008 certified and our primary products are power supplies, power converters, filters, power transformers, magnetic components, power distribution equipment, ups systems, antennas and high power radar systems. The applications of these products include AC and DC locomotives, shipboard power, shipboard radar, airborne power, ground-based radar, and ground mobile power.

Espey services include design and development to specification, build to print, design services, design studies, environmental testing services, metal fabrication, plating and painting services, and development of automatic testing equipment. Espey manufacturing is vertically integrated, meaning that the Company produces individual components (including inductors), populates printed circuit boards, fabricates metalwork, paints, wires, qualifies, and fully tests items, mechanically, electrically and environmentally, in house. Portions of the manufacturing process are subcontracted to vendors from time to time.

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. Espey contracts with the Federal Government under cage code 20950 as Espey Mfg. & Electronics Corp. and cage code 98675 as Espey Mfg. & Electronics Corp., Saratoga Industries Division.

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.

New orders received in the first three months of fiscal 2012 were approximately \$9.4 million, representing a 38.5% increase from the amount of new orders received in the first three months of fiscal 2011. 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 approximately \$40.1 million

at September 30, 2011 which includes \$27.2 million from two significant customers compared to \$31.8 million at September 30, 2010 which included \$20.3 million from three 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 fulfillment of orders, management expects net sales revenues in fiscal year 2012 to exceed net sales revenues in fiscal year 2011. In addition to the backlog, the Company currently has outstanding quotations and potential business representing approximately \$49 million in the aggregate for both repeat and new programs.

Index

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 Department of Defense spending and factors affecting the defense industry and military procurement generally.

Net sales to three significant customers represented 76.3% of the Company's total sales for the three month period ended September 30, 2011 and net sales to three significant customers represented 69.1% of the Company's total sales for the first three month period ended September 30, 2010. These sales are from long term programs in which the Company is a significant subcontractor. Historically, a small number of customers have accounted for a large percentage of the Company's total sales in any given fiscal year. Even though our business tends to be concentrated in several customers, the makeup of those customers often changes from year to 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 in order to diversify its customer base. The defense industry itself tends to be concentrated with a few large tier one defense contractors which limits the amount of diversity the Company can achieve with its customer base.

Management, along with the Board of Directors, continues to evaluate the need and use of the Company's working capital. Capital expenditures are expected to be approximately \$300,000 for fiscal 2012. Expectations are that the working capital will be used to fund orders, general operations of the business, and dividend payments.

From time to time, management along with the Mergers and Acquisitions Committee of the Board of Directors examine opportunities involving acquisitions or other strategic options, including buying certain products or product lines. The criteria for consideration are synergies with the Company's existing product base and accretion to earnings.

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 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, 2011 were \$7,993,927 as compared to \$6,026,330 for the same period in 2010, representing a 32.7% increase. The increase for the three months ended September 30, 2011 was primarily due to the shipment of a high power radar system that the Company does not regularly build.

For the three months ended September 30, 2011 and 2010 gross profits were \$2,001,808 and \$1,650,532, respectively. Gross profit as a percentage of sales was 25.0% and 27.4%, for the three months ended September 30, 2011 and 2010, respectively. The primary factors in determining gross profit and net income are overall sales levels and 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 gross profit percentage decrease in the three months ended September 30, 2011 as compared to September 30, 2010 was primarily the result of one large order shipped during the quarter that had a lower gross profit percentage than the average gross profit percentage from the previous period. This order was for a high power radar system referred to above.

Index

Selling, general and administrative expenses were \$742,867 for the three months ended September 30, 2011; an increase of \$50,158, compared to the three months ended September 30, 2010. The increase for the three months ended September 30, 2011 relates primarily to an increase in salary expense and training seminars.

Interest income for the three months ended September 30, 2011 decreased as compared to the three months ended September 30, 2010 due to decreased interest rates and related interest income on the Company's cash and cash equivalents and investment securities. Other income decreased due to a decrease in funds received related to an insurance claim.

The Company does not believe there is significant risk associated with its investment policy, since at September 30, 2011 all of the investments were primarily represented by short-term liquid investments.

The effective income tax rate at September 30, 2011 and 2010 was 28.5% and 28.2%, 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" under The American Jobs Creation Act of 2004 and the benefit derived from the ESOP dividends paid on allocated shares.

Net income for the three months ended September 30, 2011, was \$926,904 or \$.43 and \$.42 per share, basic and diluted, respectively, compared to \$753,539 or \$.35 per share, both basic and diluted, for the three months ended September 30, 2010. The increase in net income per share was mainly due to higher sales and gross profit offset by higher 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 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, 2011 was approximately \$26.8 million. During the three months ended September 30, 2011 and 2010 the Company did not repurchase any shares of its common stock. Under existing authorizations from the Company's Board of Directors, as of September 30, 2011, management is authorized to purchase an additional \$2 million of Company stock.

	Three Months Ended	
	September 30, 2011	September 30, 2010
Net cash provided by operating activities	\$1,634,773	\$ 1,439,380
Net cash (used in) provided by investing activities	(632,232)	2,247,353
Net cash used in financing activities	(361,957)	(385,571)

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 increased in the first three months of fiscal 2012 due to the amount of investment securities purchased during the current period. The slight decrease in cash used in financing activities is due primarily to dividends on common stock with the offsetting effect of the sale of treasury stock.

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, 2011 and 2010, the Company expended \$40,370 and \$107,247, respectively, for plant improvements and new equipment. The Company has budgeted approximately \$300,000 for new equipment and plant improvements in fiscal 2012. Management anticipates that the funds required will be available from current operations.

Index

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, 2011.

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 4. 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.

Index

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, 2011, the Company sold 2,331 shares to the ESOP in connection with participants of the ESOP electing to reinvest dividends paid on ESOP shares. The aggregate gross proceeds from the shares of common stock sold were \$19,231. 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 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

Index

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/ Mark St. Pierre
Mark St. Pierre
President and Chief Executive
Officer

/s/ David O'Neil
David O'Neil
Treasurer and Principal Financial
Officer

November 9, 2011
Date