ESPEY MFG & ELECTRONICS CORP
Form 10-K
September 08, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10 – K

S ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the fiscal year ended June 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 1-4383

ESPEY MFG. & ELECTRONICS CORP.
(Exact name of registrant as specified in its charter)

NEW YORK	14-1387171
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

233 Ballston Avenue, Saratoga Springs, NY 12866
(Address of principal executive offices including Zip Code)

(Registrant's telephone number including area code) (518)245-4400

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock $.33-1/3 par value	NYSE - Amex
Common Stock Purchase Rights	NYSE - Amex

Securities registered pursuant to Section 12 (g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
£ Yes S No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
£ Yes S No

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.
S Yes £ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. £

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	S Smaller reporting company

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was $36,157,493 million based upon the closing sale price of $23.76 on the NYSE - Amex on December 31, 2010.

At September 8, 2011, there were 2,320,960 shares outstanding of the registrant's Common stock, $.33-1/3 par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement relating to the 2011 Annual Meeting of Shareholders, to be filed with the Securities and Exchange Commission, are incorporated by reference in Part III, Items 10 through 14 on Form 10-K as indicated herein.

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Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements that are based on management's expectations, estimates, projections and assumptions. Words such as "expects," "anticipates," "plans," "believes," "scheduled," "estimates" variations of these words and similar expressions are intended to identify forward-looking statements. Forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, as amended. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict. Therefore, actual future results and trends may differ materially from what is forecast in forward-looking statements due to a variety of factors, including, without limitation:

- Changing priorities or decreases in the U.S. government's defense budget (including changes in priorities in response to terrorist threats, improvement of homeland security and the overall financial health of the U.S. Government);
- Termination of government contracts due to unilateral government action;
- Differences in anticipated and actual program performance, including the ability to perform under long-term fixed-price contracts within estimated costs, and performance issues with key suppliers and subcontractors;
- Potential of changing prices for energy and raw materials.

All forward-looking statements speak only as of the date of this report or, in the case of any document incorporated by reference, the date of that document. All subsequent written and oral forward-looking statements attributable to the Company or any person acting on the Company's behalf are qualified by the cautionary statements in this section. The Company does not undertake any obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date of this report.

PART I

Item 1. Business

General

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, plates, 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.

Espey is on the eligible list of contractors with the United States Department of Defense and generally is automatically solicited by Defense Department procurement agencies for their needs falling within the major classes of products produced by the Company. 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.

In the fiscal years ended June 30, 2011 and 2010, the Company's total sales were $29,499,504 and $28,900,013, respectively. Sales to two customers accounted for 31% and 31% of total sales in 2011. Sales to three customers accounted for 22%, 13% and 13% of total sales in 2010.

Export sales in 2011 and 2010 were approximately $4,769,000 and $5,324,000, respectively.

Sources of Raw Materials

The Company has never experienced any significant delay or shortage with respect to the purchase of raw materials and components used in the manufacture of its products, and has at least two potential sources of supply for a majority of its raw materials. However, certain components used in our products are available from only a limited number of sources, and other components are only available from a single source. Despite the risk associated with limited or single source suppliers, the benefits of higher quality goods and timely delivery minimize and often limit any potential risk and can eliminate problems with part failures during production.

Sales Backlog

At September 7, 2011, the Company's backlog was approximately $40.5 million. The total backlog at June 30, 2011 was approximately $38.7 million compared to approximately $31 million at June 30, 2010. The Company's total backlog represents the estimated remaining sales value of work to be performed under firm contracts. The Company's backlog and risks associated with government contracts is discussed in greater detail in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 6 below.

It is presently anticipated that a minimum of $30 million of orders comprising the June 30, 2011 backlog will be filled during the fiscal year ending June 30, 2012. The minimum of $30 million does not include any shipments, which may be made against orders subsequently received during the fiscal year ending June 30, 2012. The estimate of the June 30, 2011 backlog to be shipped in fiscal 2012 is subject to future events, which may cause the amount of the backlog actually shipped to differ from such estimate.

Marketing and Competition

The Company markets its products primarily through its own direct sales organization. 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 some cases external sales representatives 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 pursues opportunities from the United States Department of Defense as a prime contractor.

There is competition in all classes of products manufactured by the Company, ranging from divisions of the largest electronic companies to 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 the United States and foreign government appropriations and program allocations, the competition for available military business, and government termination of orders for convenience.

The Company's business is not considered to be seasonal. Also, management believes that due to the nature of the Company's business, the Company will not be adversely affected by recessionary factors in the U.S. economy generally. Future cuts to the U.S. Government’s defense budget could negatively impact the Company’s business. Although the anticipated partial disengagement of the United States military presence from both Iraq and Afghanistan as well as recent political discourse are indicative of a likely reduction in military and defense appropriations by Congress, the Company does not believe that these developments will adversely affect its business for several reasons:

- Budget cuts will most likely come from expensive platforms and personnel (especially in overseas deployments) which are not the focus of our strategy. Furthermore, cuts to big budget “marquis” programs tend to favor the legacy programs and upgrades which are Espey’s focus.
- When it is judged that upgrade of a legacy system is more cost-effective than a brand-new development, functionality and therefore the electrical power requirement is almost always increased, resulting in more demand for Espey’s products.
- It is unlikely that the U.S. will cede its leadership role in military affairs worldwide when political stability or sea lanes are at risk, and this fact is likely to mitigate any action leading to more than marginal cuts to defense spending.
- As a hedge to expected cuts that do occur, Espey intends to maintain 20% -25% of its sales to non-defense applications.

Research and Development

The Company's expenditures for research and development were approximately $50,103 and $50,166 in fiscal 2011 and 2010, respectively. Some of the Company's engineers and technicians spend varying degrees of time on either development of new products or improvements of existing products. A majority of these expenditures relate to research that is required by Espey engineers to support a request for a quotation from a customer having a product-specific custom need usually associated with stringent size and weight requirements.

Employees

The Company had 166 employees as of September 7, 2011. Approximately 40% of these employees are represented by the International Brotherhood of Electrical Workers Local #1799. A collective bargaining agreement was approved in June 2008. The four-year agreement expires on June 30, 2012. The contract provided for pay increases of 4%, 3.75%, 3.75% and 4% for each year, respectively, of the four-year contract. Relations with the Union are considered good. Union membership at September 7, 2011 was 70 people.

Government Regulations

Compliance with federal, state and local laws regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, did not in fiscal year 2011, and the Company believes will not in fiscal year 2012, have a material effect upon the capital expenditures, net income, or competitive position of the Company.

The Company's U.S. government contract and subcontract orders are funded by government budgets, which operate on an October-to-September fiscal year. In February of each year, the President of the United States presents to Congress a proposed budget for the upcoming fiscal year. This budget includes recommended appropriations for every federal agency and is the result of months of policy and program reviews throughout the executive branch. From February through September of each year, the appropriations and authorization committees of Congress review the President's budget proposals and establish the funding levels for the upcoming fiscal year in appropriations and authorization legislation. Once these levels are enacted into law, the Executive Office of the President administers the funds to the agencies.

There are two primary risks associated with this process. First, the process may be delayed or disrupted because of congressional schedules, negotiations over funding levels for programs or unforeseen world events, which could, in turn, alter the funding for a program or contract. Second, funding for multi-year contracts can be changed by future appropriations, which could affect the timing of funds, schedules and program content.

Also, our international sales are denominated in United States currency. Consequently, changes in exchange rates that strengthen the United States dollar could increase the price in local currencies of our products in foreign markets and make our products relatively more expensive than competitors' products.

U.S. Government Defense Contracts and Subcontracts

Generally, U.S. government contracts are subject to procurement laws and regulations. Some of the Company's contracts are governed by the Federal Acquisition Regulation (FAR), which lays out uniform policies and procedures for acquiring goods and services by the U.S. government, and agency-specific acquisition regulations that implement or supplement the FAR. For example, the Department of Defense implements the FAR through the Defense Federal Acquisition Regulation (DFAR).

The FAR also contains guidelines and regulations for managing a contract after award, including conditions under which contracts may be terminated, in whole or in part, at the government's convenience or for default. If a contract is terminated for the convenience of the government, a contractor is entitled to receive payments for its allowable costs and, in general, the proportionate share of fees or earnings for the work done. If a contract is terminated for default, the government generally pays for only the work it has accepted. These regulations also subject the Company to financial audits and other reviews by the government of its costs, performance, accounting and general business practices relating to its contracts, which may result in adjustment of the Company's contract-related costs and fees.

Item 2. Property

The Company's entire operation, including manufacturing and engineering facilities, is located in Saratoga Springs, New York.

The Saratoga Springs plant, which the Company owns, consists of various adjoining one-story buildings on a 22 acre site, approximately eight acres of which is unimproved. The property is not subject to mortgage indebtedness or any other material encumbrance. The plant has a sprinkler system throughout and contains approximately 151,000 square feet of floor space, of which 90,000 is used for manufacturing, 24,000 for engineering, 33,000 for shipping and climatically secured storage, and 4,000 for offices. The offices, engineering and some manufacturing areas are air-conditioned. In addition to assembly and wiring operations, the plant includes facilities for varnishing, potting, plating, impregnation and spray-painting operations. The manufacturing operation also includes a complete machine shop, with welding and sheet metal fabrication facilities adequate for substantially all of the Company's current operations. Besides normal test equipment, the Company maintains a sophisticated on-site environmental test facility. In addition to meeting all of the Company's in-house needs, the plating, machine shop and environmental facilities are available to other companies on a contract basis.

Item 3. Legal Proceedings

None

PART II

Item 5. Market for the Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities

Price Range of Common Stock

The table below shows the range of high and low prices for the Company's common stock on the NYSE - Amex (symbol "ESP"), the principal market for trading in the common stock, for each quarterly period for the last two fiscal years ended June 30:

2011	High	Low
First Quarter	22.50	18.13
Second Quarter	25.83	21.00
Third Quarter	25.87	19.50
Fourth Quarter	29.20	23.22
2010		
First Quarter	18.70	14.60
Second Quarter	21.08	17.40
Third Quarter	21.14	17.80
Fourth Quarter	20.35	18.10

Holders

The approximate number of holders of record of the common stock was 99 on September 7, 2011 according to records of the Company's transfer agent. Included in this number are shares held in "nominee" or "street" name and, therefore, the number of beneficial owners of the common stock is believed to be substantially in excess of the foregoing number.

Dividends

The Company paid cash dividends on common stock of $1.90 per share for the fiscal years ended June 30, 2011 and 2010, which included a special dividend of $1.00 per share during each such fiscal year. The Board of Directors has authorized the payment of a fiscal 2012 first quarter dividend of $.225 payable September 30, 2011 to shareholders of record on September 9, 2011. We anticipate that regular quarterly dividends will be paid for the foreseeable future. There is no assurance that the Board of Directors will declare a special dividend during the fiscal year ending June 30, 2012.

During fiscal 2011, the Company sold common stock to certain employees and directors as they exercised existing stock options granted under a shareholder approved plan. During the year, 23,800 shares were sold at prices that ranged from $8.98 a share to $21.54 a share. The securities were sold for cash. Proceeds are used for general working capital purposes.

The Company did not make any open market purchases of equity securities in the fiscal 2011 fourth quarter.

The following table sets forth information as of June 30, 2011 with respect to compensation plans under which equity securities of the Company may be issued.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of Securities remaining available for future issuance under equity compensation plan (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	132,400	18.62	310,600
Equity compensation plans not approved by security holders	--		--
Total	132,400		310,600

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Business Outlook

Management expects revenues in fiscal 2012 to increase approximately 5% over fiscal year 2011. Expectations are for product mix and margins to remain favorable for fiscal year 2012. During fiscal 2011 new orders received by the Company were approximately $37.2 million. The order backlog of approximately $38.7 million at June 30, 2011 gives the Company a solid base of future sales. It is presently anticipated that a minimum of $30 million of orders comprising the June 30, 2011 backlog will be filled during the fiscal year ending June 30, 2012. The minimum of $30 million does not include any shipments, which may be made against orders subsequently received during the fiscal year ending June 30, 2012. See discussions below for further detail on the customer mix included in the backlog.

In addition to the backlog, the Company currently has outstanding quotations representing in excess of $43.9 million in the aggregate for both repeat and new programs. Many potential orders are currently being discussed and negotiated with existing and potential new customers. 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.

Two significant customers in fiscal 2011 represented 62% of the Company's total sales and three significant customers in fiscal 2010 represented 48% of the Company's total sales. These sales are in connection with multiyear programs in which the Company is a significant subcontractor. The June 30, 2011 backlog of $38.7 million includes orders from two customers that represent 48% and 15%, respectively, of the total backlog. A loss of one of these customers or programs related to these customers would significantly impact the Company. 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 required to fund orders, dividend payments, and general operations of the business. 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.

Results of Operations

Net Sales for fiscal years ended June 30, 2011 and 2010, were $29,499,504 and $28,900,013, respectively, a 2% increase. This increase can be attributed to the contract specific nature of the Company’s business and the timing of deliveries on these contracts. More specifically, shipments of power supplies increased by approximately $4.9 million offset by a decrease of $3 million in transformer and antenna shipments and a decrease of $1.1 million in engineering design related billings in fiscal 2011.

For the fiscal years ended June 30, 2011 and 2010 gross profits were $8,206,199 and $7,763,296, respectively. Gross profit as a percentage of sales was 27.8% and 26.9%, for fiscal 2011 and 2010, 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 that 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 fiscal 2011 as compared to fiscal 2010, was primarily the result of favorable product mix with only minor cost overruns related to certain products.

In addition to favorable product mix, management is implementing several "lean management" principles which have created efficiencies in the manufacturing process. These efficiencies have allowed for greater production capacity and increased gross profit. Employment of full time equivalents at June 30, 2011 was 165 compared to 169 people at June 30, 2010.

Selling, general and administrative expenses were $2,905,916 for the fiscal year ended June 30, 2011, a decrease of $100,601, or 3.3% as compared to the prior year. The decrease for fiscal 2011 relates primarily to a decrease in salary expense.

Other income for the fiscal years ended June 30, 2011 and 2010 was $81,259 and $142,866, respectively. The decrease is attributable to lower interest rates and related interest income on the Company's cash and cash equivalents and short term investments. The Company does not believe that there is a significant risk associated with its investment policy. At June 30, 2011 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 was 28.3% in fiscal 2011 and 27.2% in fiscal 2010. 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 dividends paid on allocated ESOP shares.

Net income for fiscal 2011, was $3,857,537 or $1.79 and $1.77 per share, basic and diluted, compared to net income of $3,564,962 or $1.67 per share, both basic and diluted, respectively, for fiscal 2010. The increase in net income per share was primarily due to higher sales, higher gross profit on sales, and lower 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 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 two fiscal years.

The Company's working capital as of June 30, 2011 and 2010 was $26,124,431 and $25,844,991, respectively. During the three months ended June 30, 2011 and 2010 the Company did not repurchase any shares of its common stock. During the fiscal year ended June 30, 2011 and 2010 the Company repurchased 23,342 and 23,513 shares, respectively, of its common stock for a total purchase price of $575,246 and $452,155, respectively. All shares were purchased from the Company's ESOP. Under existing authorizations from the Company's Board of Directors, as of June 30, 2011, management is authorized to purchase an additional $2,000,000 million of Company stock.

The table below presents the summary of cash flow information for the fiscal year indicated:

	2011	2010
Net cash provided by operating activities	$4,913,449	$6,904,771
Net cash provided by (used in) investing activities	4,515,760	(1,170,683)
Net cash used in financing activities	(4,208,464)	(4,034,341)

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 payments of accounts payable. Net cash provided by investing activities increased in fiscal 2011 due to a decrease in purchases of short term investments. The increase in cash used in financing activities is due primarily to an increase in the purchase 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.

Management believes that the Company's reserve for bad debts of $3,000 is adequate given the customers with whom the Company does business. Historically, bad debt expense has been minimal.

During fiscal year 2011 and fiscal 2010, the Company expended $607,311 and $436,502, 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.

Critical Accounting Policies and Estimates

Our significant accounting policies are described in note 2 to the financial statements. We believe our most critical accounting policies include revenue recognition and cost estimation on our contracts.

Revenue Recognition and Estimates

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 schedules. 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.

Item 7. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Espey Mfg. & Electronics Corp.
Saratoga Springs, New York

We have audited the accompanying balance sheets of Espey Mfg. & Electronics Corp. as of June 30, 2011 and 2010, and the related statements of income, stockholders' equity, and cash flows for each of the years in the two-year period ended June 30, 2011. Espey Mfg. & Electronics Corp.'s management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Espey Mfg. & Electronics Corp. as of June 30, 2011 and 2010, and the results of its operations and its cash flows for each of the years in the two-year period ended June 30, 2011 in conformity with accounting principles generally accepted in the United States of America.

/s/EFP Rotenberg, LLP
Rochester, New York
September 8, 2011

Espey Mfg. & Electronics Corp.
Balance Sheet
June 30, 2011 and
2010

	2011	2010
ASSETS		
Cash and cash equivalents	$9,695,811	$4,475,066
Short term investments	1,946,214	7,111,182
Trade accounts receivable, net	6,266,765	5,495,251
Inventories:		
Raw materials	1,273,582	1,233,597
Work-in-process	1,085,278	1,490,749
Costs related to contracts in process, net of progress		
payments of $126,361 in 2011 and $142,492 in 2010	8,220,200	8,217,040
Total inventories	10,579,060	10,941,386
Deferred tax asset	360,553	229,086
Prepaid expenses and other current assets	208,904	185,832
Total current assets	29,057,307	28,437,803
Property, plant and equipment, net	2,703,014	2,717,330
Loan receivable	108,303	11,546
Total assets	$31,868,624	$31,166,679
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$1,453,707	$1,607,147
Accrued expenses:		
Salaries, wages and commissions	412,555	203,435
Vacation	623,757	544,021
Other	121,026	177,086
Payroll and other taxes withheld and accrued	44,085	46,330
Income taxes payable	277,746	14,793
Total current liabilities	2,932,876	2,592,812
Deferred tax liability	270,729	127,148
Total liabilities	3,203,605	2,719,960
Common stock, par value $.33-1/3 per share		
Authorized 10,000,000 shares; Issued 3,029,874 shares in 2011		
and 2010. Outstanding 2,320,960 and 2,319,876 in 2011 and		
2010, respectively (includes 157, 500 and 179,166 Unearned		
ESOP Shares)	1,009,958	1,009,958
Capital in excess of par value	14,674,189	14,172,284
Retained earnings	22,780,026	23,002,981
	38,464,173	38,185,223
Less: Unearned ESOP shares	(2,275,872)	(2,588,954)

Cost of 708,914 and 709,998 shares of common stock		
in treasury in 2011 and 2010, respectively	(7,523,282)	(7,149,550)
Total stockholders' equity	28,665,019	28,446,719
Total liabilities and stockholders' equity	$31,868,624	$31,166,679

The accompanying notes are an integral part of the financial statements.

Espey Mfg. & Electronics Corp.
Statements of Income
Years Ended June 30, 2011 and 2010

	2011	2010
Net sales	$29,499,504	$28,900,013
Cost of sales	21,293,305	21,136,717
Gross profit	8,206,199	7,763,296
Selling, general and administrative expenses	2,905,916	3,006,517
Operating income	5,300,283	4,756,779
Other income		
Interest and dividend income	56,154	99,373
Other	25,105	43,493
Total other income	81,259	142,866
Income before income taxes	5,381,542	4,899,645
Provision for income taxes	1,524,005	1,334,683
Net income	$3,857,537	$3,564,962
Net income per share:		
Basic	$1.79	$1.67
Diluted	$1.77	$1.67
Weighted average number of shares outstanding:		
Basic	2,151,443	2,129,417
Diluted	2,176,299	2,137,799

The accompanying notes are an integral part of the financial statements.

Espey Mfg. & Electronics Corp.
Statements of Changes in Stockholders' Equity
Years Ended June 30, 2011 and 2010

	Outstanding Common Shares	Amount	Capital in Excess of Par Value	Unearned ESOP Shares	Retained Earnings
Balance as of June 30, 2009	2,314,803	$1,009,958	$13,755,808	$(2,914,077)	$23,485,675
Net income, 2010					3,564,962
Stock options exercised	8,100		68,755		
Stock option expense			94,423		
Dividends paid on common stock $1.90 per share					(4,047,656)
Tax effect of stock options exercised			3,138		
Sale of treasury stock to ESOP	20,486		157,742		
Purchase of treasury stock	(23,513)				
Reduction of unearned ESOP shares			92,418	325,123	
Balance as of June 30, 2010	2,319,876	$1,009,958	$14,172,284	$(2,588,954)	$23,002,981
Net income, 2011					3,857,537
Stock options exercised	23,800		227,904		
Stock option expense			66,237		
Dividends paid on common stock $1.90 per share					(4,080,492)
Tax effect of stock options exercised			10,939		
Sale of treasury stock to ESOP	626		6,917		
Purchase of treasury stock	(23,342)				
Reduction of unearned ESOP shares			189,908	313,082	
Balance as of June 30, 2011	2,320,960	$1,009,958	$14,674,189	$(2,275,872)	$22,780,026

The accompanying notes are an integral part of the financial statements.

(Continued)

Espey Mfg. & Electronics Corp.
Statements of Changes in Stockholders' Equity
Years Ended June 30, 2011 and
2010

	Treasury Stock		Total
	Shares	Amount	Stockholders' Equity
Balance as of June 30, 2009	715,071	$(6,933,230)	$ 28,404,134
Net income, 2010			3,564,962
Stock options exercised	(8,100)	66,825	135,580
Stock option expense			94,423
Dividends paid on common stock $1.90 per share			(4,047,656)
Tax effect of stock options exercised			3,138
Sale of treasury stock to ESOP	(20,486)	169,010	326,752
Purchase of treasury stock	23,513	(452,155)	(452,155)
Reduction of unearned ESOP shares			417,541
Balance as of June 30, 2010	709,998	$(7,149,550)	$ 28,446,719
Net income, 2011			3,857,537
Stock options exercised	(23,800)	196,350	424,254
Stock option expense			66,237
Dividends paid on common stock $1.90 per share			(4,080,492)
Tax effect of stock options exercised			10,939
Sale of treasury stock to ESOP	(626)	5,164	12,081
Purchase of treasury stock	23,342	(575,246)	(575,246)
Reduction of unearned ESOP shares			502,990
Balance as of June 30, 2011	708,914	$(7,523,282)	$ 28,665,019

The accompanying notes are an integral part of the financial statements.

Espey Mfg. & Electronics Corp.
Statements of Cash Flows
Years Ended June 30, 2011 and 2010

	2011	2010
Cash Flows From Operating Activities:		
Net income	$3,857,537	$3,564,962
Adjustments to reconcile net income to net cash provided by operating activities:		
Excess tax benefits from share-based compensation	10,939	3,138
Stock-based compensation	66,237	94,423
Depreciation	467,296	455,592
ESOP compensation expense	502,990	417,541
Loss on disposal of assets	99,471	1,802
Deferred income tax benefit	12,114	23,644
Changes in assets and liabilities:		
Increase in trade receivables, net	(771,495)	(361,459)
(Increase) decrease in other receivables	(19)	297
Decrease in ESOP receivable due to dividends on unallocated shares	--	71,053
Decrease in inventories, net	362,326	2,087,819
(Increase) decrease in prepaid expenses and other current assets	(23,072)	47,240
(Decrease) increase in accounts payable	(153,440)	607,626
Increase (decrease) in accrued salaries, wages and commissions	209,120	(16,098)
(Decrease) increase in other accrued expenses	(56,060)	134,223
Increase in vacation accrual	79,736	23,949
(Decrease) increase in payroll and other taxes withheld and accrued	(2,245)	4,255
Increase (decrease) in income taxes payable	252,014	(255,236)
Net cash provided by operating activities	$4,913,449	$6,904,771

The accompanying notes are an integral part of the financial statements.

(Continued)

Espey Mfg. & Electronics Corp.
Statements of Cash Flows
Years Ended June 30, 2011 and 2010

	2011	2010
Cash Flows From Investing Activities:		
Additions to property, plant and equipment	(607,311)	(436,502)
Proceeds on sale of assets	54,860	--
Payment for loan receivable	(125,000)	--
Proceeds from loan receivable	28,243	27,127
Purchase of short term investments	(3,091,032)	(8,410,871)
Proceeds from maturity of short term investments	8,256,000	7,649,563
Net cash provided by (used in) investing activities	4,515,760	(1,170,683)
Cash Flows From Financing Activities:		
Sale of treasury stock	12,081	326,752
Dividends on common stock	(4,080,492)	(4,047,656)
Purchase of treasury stock	(575,246)	(452,155)
Proceeds from exercise of stock options	424,254	135,580
Excess tax benefits from share-based compensation	10,939	3,138
Net cash used in financing activities	(4,208,464)	(4,034,341)
Increase in cash and cash equivalents	5,220,745	1,699,747
Cash and cash equivalents, beginning of the year	4,475,066	2,775,319
Cash and cash equivalents, end of the year	$9,695,811	$4,475,066
Supplemental Schedule of Cash Flow Information:		
Income taxes paid	$1,238,000	$1,560,000

The accompanying notes are an integral part of the financial statements.

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Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 1. Nature of operations

Espey Mfg. & Electronics Corp. (the Company) is a manufacturer of electronic equipment used primarily in military and industrial applications. The principal markets for the Company's products are companies that provide electronic support to both military and industrial applications.

Note 2. Summary of Significant Accounting Policies

Inventory Valuation, Cost Estimation and Revenue Recognition
Raw materials are valued at weighted average cost.

Inventoried work relating to contracts in process and work in process is valued at actual production cost, including factory overhead incurred to date. Work in process represents spare units; parts and other inventory items acquired or produced to service units previously sold or to meet anticipated future orders. The cost elements of contracts in process and work in process consist of production costs of goods and services currently in process and overhead. Provision for losses on contracts is made when the existence of such losses becomes probable and estimable. The costs attributed to units delivered under contracts are based on the estimated average cost of all units expected to be produced. Certain contracts are expected to extend beyond twelve months.

Revenue is recognized on contracts in the period in which the units are delivered and billed (units-of-delivery method). 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 schedules. 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.

Depreciation
Depreciation of plant and equipment is computed on a straight-line basis over the estimated useful lives of the assets.

Estimated useful lives of depreciable assets are as follows:

Buildings and improvements	10 – 40 years
Machinery and equipment	3 - 20 years
Furniture and fixtures	7 – 10 years

Income Taxes
The Company follows the provisions of ASC Topic 740-10, "Accounting for Income Taxes."

Under the provisions of ASC 740-10, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred taxes and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. In addition, ASC 740-10 requires that the tax benefit of tax-deductible dividends on unallocated ESOP shares be recorded as a direct addition to retained earnings rather than as a reduction of income tax expense.

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 2. Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents
Cash and cash equivalents consist of cash in banks, certificates of deposit, and money market funds. The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

Short-term investments include certificates of deposit with maturities greater than three months to a year.

Accounts receivable and allowance for doubtful accounts
The Company extends credit to its customers in the normal course of business and collateral is generally not required for trade receivables. Exposure to credit risk is controlled through the use of credit approvals, credit limits and monitoring procedures. Accounts receivable are reported net of an allowance for doubtful accounts. The Company estimates the allowance based on its analysis of specific balances. An account is generally considered past due after thirty (30) days from the invoice date. Based on these factors, there was an allowance for doubtful accounts of $3,000 at June 30, 2011. Changes to the allowance for doubtful accounts are charged to expense and reduced by charge-offs, net of recoveries.

Per Share Amounts
ASC 260-10 “Earnings Per Share” requires the Company to calculate net income (loss) per share based on basic and diluted net income (loss) per share, as defined. Basic EPS excludes dilution and is computed by dividing net income (loss) by the weighted average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The dilutive effect of outstanding options issued by the Company are reflected in diluted EPS using the treasury stock method. Under the treasury stock method, options will only have a dilutive effect when the average market price of common stock during the period exceeds the exercise price of the options.

Comprehensive Income
Comprehensive Income for the years ended June 30, 2011 and 2010 is equal to net income.

Use of Estimates
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Investment Tax Credits
Investment tax credits are accounted for as a reduction of income tax expense in the year taxes payable are reduced.

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

Recently Issued Accounting Standards
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. Adoption had will have no effect on the Company's financial statements.

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 2. Summary of Significant Accounting Policies, Continued

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 presently has no items classified as OCI and expects the update to have minimal effect on its financial statements.

Impairment of Long-Lived Assets
Long-lived assets, including property, plant, and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

Concentrations of Risk
The market for our defense electronics products is largely dependent on the availability of new contracts from the United States and foreign governments to prime contractors to which we provide components. Any decline in expenditures by the United States or foreign governments may have an adverse effect on our financial performance.

Generally, U.S. government contracts are subject to procurement laws and regulations. Some of the Company's contracts are governed by the Federal Acquisition Regulation (FAR), which lays out uniform policies and procedures for acquiring goods and services by the U.S. government, and agency-specific acquisition regulations that implement or supplement the FAR. For example, the Department of Defense implements the FAR through the Defense Federal Acquisition Regulation (DFAR).

The FAR also contains guidelines and regulations for managing a contract after award, including conditions under which contracts may be terminated, in whole or in part, at the government's convenience or for default. If a contract is terminated for the convenience of the government, a contractor is entitled to receive payments for its allowable costs and, in general, the proportionate share of fees or earnings for the work done. If a contract is terminated for default, the government generally pays for only the work it has accepted. These regulations also subject the Company to financial audits and other reviews by the government of its costs, performance, accounting and general business practices relating to its contracts, which may result in adjustment of the Company's contract-related costs and fees.

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 3. Contracts in Process

Contracts in process at June 30, 2011 and 2010 are as follows:

		2011		2010
Gross contract value	$	38,655,707	$	30,995,710
Costs related to contracts in process, net of progress payments of $126,361 in fiscal 2011 $142,492 in fiscal 2010	$	8,220,200	$	8,217,040

Included in costs relating to contracts in process at June 30, 2011 and 2010 are costs of $779,568 and $1,806,212, respectively, relative to contracts that may not be completed within the ensuing year. Under the units-of-delivery method, the related sale and cost of sales will not be reflected in the statement of income until the units under contract are shipped.

Note 4. Property, Plant and Equipment

A summary of the original cost of property, plant and equipment at June 30, 2011 and 2010 is as follows:

		2011		2010
Land	$	45,000	$	45,000
Building and improvements		4,104,132		4,668,556
Machinery and equipment		7,352,055		6,994,505
Furniture and fixtures		160,867		161,825
		11,662,054		11,869,886
Accumulated depreciation		(8,959,040)		(9,152,556)
Property, plant and equipment, net	$	2,703,014	$	2,717,330

Depreciation expense was $467,296 and $455,592, during the years ended June 30, 2011 and 2010, respectively.

Note 5. Pension Expense

Under terms of a negotiated union contract, the Company is obligated to make contributions to a union-sponsored defined benefit pension plan covering eligible employees. Such contributions and expenses are based upon hours worked at a specified rate and amounted to $102,281 in fiscal 2011 and $102,414 in fiscal 2010.

The Company sponsors a 401(k) plan with employee and employer matching contributions. The employer match is 10% of the employee contribution and was $33,664 and $34,462, for fiscal years 2011 and 2010, respectively.

Note 6. Provision for Income Taxes

A summary of the components of the provision for income taxes for the years ended June 30, 2011 and 2010 is as follows:

	2011	2010