

ESPEY MFG & ELECTRONICS CORP  
Form 10-Q  
February 12, 2015

**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 December 31, 2014**

**Commission File Number I-4383**

**ESPEY MFG. & ELECTRONICS CORP.**

(Exact name of registrant as specified in its charter)

**NEW YORK**            **14-1387171**

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

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

(Address of principal executive offices)

**518-584-4100**

(Registrant's telephone number, including area code)

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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       Non-accelerated filer  
 Accelerated file       Smaller reporting company

Indicate by check mark whether the registrant is a shell company.

Yes       No

At February 12, 2015, there were 2,358,157 shares outstanding of the registrant's Common stock, \$.33-1/3 par value.

ESPEY MFG. & ELECTRONICS CORP.

Quarterly Report on Form 10-Q

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## PART I: FINANCIAL INFORMATION

## ESPEY MFG. &amp; ELECTRONICS CORP.

## Balance Sheets

December 31, 2014 (Unaudited) and June 30, 2014

	December 31, 2014	June 30, 2014
<b>ASSETS:</b>		
Cash and cash equivalents	\$ 10,237,837	\$ 9,556,891
Investment securities, available for sale	4,393,158	4,910,893
Trade accounts receivable, net of allowance of \$3,000 at December 31, 2014 and June 30, 2014	3,386,994	3,194,678
Income tax receivable	265,996	943,234
Inventories:		
Raw materials	1,642,771	1,616,990
Work-in-process	906,414	792,618
Costs relating to contracts in process, net of advance payments of \$19,626 at December 31, 2014 and \$142,616 at June 30, 2014	8,974,607	8,201,642
Total inventories	11,523,792	10,611,250
Deferred income taxes	229,088	324,823
Prepaid expenses and other current assets	62,340	177,776
Total current assets	30,099,205	29,719,545
Property, plant and equipment, net	2,504,965	2,678,901
Total assets	\$ 32,604,170	\$ 32,398,446
<b>LIABILITIES AND STOCKHOLDERS' EQUITY:</b>		
Accounts payable	\$ 877,533	\$ 727,281
Accrued expenses:		
Salaries, wages and commissions	173,765	413,989
Vacation	532,743	693,286
ESOP payable	159,928	—
Other	199,920	579,953
Payroll and other taxes withheld	47,724	53,553
Total current liabilities	1,991,613	2,468,062
Deferred income taxes	227,650	283,439
Total liabilities	2,219,263	2,751,501
Commitments and contingencies (see Note 5)		
Common stock, par value \$.33-1/3 per share.		
Authorized 10,000,000 shares; Issued 3,029,874 shares on December 31, 2014 and June 30, 2014. Outstanding 2,355,357 and 2,368,110 on December 31, 2014 and June 30, 2014, respectively (includes 88,333 and 97,500 unearned ESOP shares)		
	1,009,958	1,009,958
Capital in excess of par value	16,484,513	16,429,220

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Accumulated other comprehensive income	(2,850	)	(1,437	)
Retained earnings	21,944,926		20,946,940	
	39,436,547		38,384,681	
Less: Unearned ESOP shares	(1,408,872	)	(1,408,872	)
Treasury shares, cost of 674,517 and 661,764 shares on December 31, 2014 and June 30, 2014, respectively	(7,642,768	)	(7,328,864	)
Total stockholders' equity	30,384,907		29,646,945	
Total liabilities and stockholders' equity	\$ 32,604,170		\$ 32,398,446	

See accompanying notes to the financial statements.

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## ESPEY MFG. &amp; ELECTRONICS CORP.

## Statements of Comprehensive Income (Unaudited)

Three and Six months Ended December 31, 2014 and 2013

	Three months Ended December 31,		Six months Ended December 31,	
	2014	2013	2014	2013
Net sales	\$5,697,083	\$6,569,641	\$11,390,555	\$13,490,596
Cost of sales	3,438,348	5,673,627	7,321,741	10,399,446
Gross profit	2,258,735	896,014	4,068,814	3,091,150
Selling, general and administrative expenses	633,177	786,560	1,231,379	1,554,535
Operating income	1,625,558	109,454	2,837,435	1,536,615
Other income				
Interest income	9,061	9,646	17,054	20,415
Other	10,937	31,425	20,594	46,137
Total other income	19,998	41,071	37,648	66,552
Income before income taxes	1,645,556	150,525	2,875,083	1,603,167
Provision for income taxes	426,474	39,373	744,780	443,108
Net income	\$1,219,082	\$111,152	\$2,130,303	\$1,160,059
Other comprehensive income, net of tax:				
Unrealized loss on investment securities	(1,093 )	(221 )	(1,413 )	(350 )
Total comprehensive income	\$1,217,989	\$110,931	\$2,128,890	\$1,159,709
Net income per share:				
Basic	\$0.54	\$0.05	\$0.94	\$0.52
Diluted	\$0.54	\$0.05	\$0.93	\$0.51
Weighted average number of shares outstanding:				
Basic	2,265,460	2,242,436	2,268,205	2,236,754
Diluted	2,274,004	2,297,463	2,281,049	2,281,643
Dividends per share:	\$0.2500	\$1.2500	\$0.5000	\$1.5000

See accompanying notes to the financial statements.



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## ESPEY MFG. &amp; ELECTRONICS CORP.

## Statements of Cash Flows (Unaudited)

Six months Ended December 31, 2014 and 2013

	December 31, 2014	December 31, 2013
Cash Flows from Operating Activities:		
Net income	\$ 2,130,303	\$ 1,160,059
Adjustments to reconcile net income to net cash provided by operating activities:		
Excess tax benefits from share-based compensation	(26,835)	(26,242)
Stock-based compensation	26,058	52,243
Depreciation	227,753	218,056
ESOP compensation expense	208,678	283,663
Loss on disposal of assets	233	13
Deferred income tax	40,707	32,669
Changes in assets and liabilities:		
(Increase) decrease in trade receivable, net	(192,316)	2,875,613
Decrease (increase) in income taxes receivable	677,238	(442,540)
(Increase) decrease in inventories	(912,542)	9,943
Decrease in prepaid expenses and other current assets	115,436	222,530
Increase (decrease) in accounts payable	150,252	(427,474)
Decrease in accrued salaries, wages and commissions	(240,224)	(73,945)
Decrease in vacation accrual	(160,543)	(63,695)
Decrease in ESOP payable	(48,750)	(174,999)
Decrease in other accrued expenses	(380,033)	(353,633)
Decrease in payroll & taxes withheld and accrued	(5,829)	(50,891)
Increase (decrease) in income taxes payable	26,835	(404,221)
Net cash provided by operating activities	1,636,421	2,837,149
Cash Flows from Investing Activities:		
Additions to property, plant & equipment	(54,050)	(624,785)
Proceeds from loan receivable	—	21,567
Purchase of investment securities	(1,427,174)	(1,619,207)
Proceeds from sale/maturity of investment securities	1,942,735	830,000
Net cash provided by (used in) investing activities	461,511	(1,392,425)
Cash Flows from Financing Activities:		
Dividends on common stock	(1,132,317)	(3,357,828)
Purchase of treasury stock	(320,504)	—
Proceeds from exercise of stock options	9,000	215,553
Excess tax benefits from share-based compensation	26,835	26,242
Net cash used in financing activities	(1,416,986)	(3,116,033)
Increase (decrease) in cash and cash equivalents	680,946	(1,671,309)
Cash and cash equivalents, beginning of period	9,556,891	9,888,628

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Cash and cash equivalents, end of period	\$ 10,237,837	\$ 8,217,319
Supplemental Schedule of Cash Flow Information		
Income taxes paid	\$ —	\$ 1,257,200

See accompanying notes to the financial statements.

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ESPEY MFG. &amp; 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, 2014. Certain reclassifications may have been made to the prior year financial statements to conform to the current year presentation.

## Note 2. Investment in Fair Value

ASC 820 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

§ Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

§ Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

§ Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investment securities at December 31, 2014 and June 30, 2014 consist of certificates of deposit and municipal bonds which are classified as available-for-sale securities and have been determined to be level 1 assets. The cost, gross unrealized gains, gross unrealized losses and fair value of available-for-sale securities by major security type at December 31, 2014 and June 30, 2014 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2014				
Certificates of deposit	\$3,728,000	\$ —	\$ —	\$3,728,000
Municipal bonds	669,542	1,920	(6,304 )	665,158
Total investment securities	\$4,397,542	\$ 1,920	\$ (6,304 )	\$4,393,158
June 30, 2014				
Certificates of deposit	\$4,063,000	\$ —	\$ —	\$4,063,000

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Municipal bonds	850,103	2,857	(5,067 )	847,893
Total investment securities	\$4,913,103	\$ 2,857	\$ (5,067 )	\$4,910,893

The portfolio is diversified and highly liquid and primarily consists of investment grade fixed income instruments. At December 31, 2014, the Company did not have any investments in individual securities that have been in a continuous loss position to be temporary for more than 12 months. Due to the fact that the decline in market value is attributable to changes in interest rates and not credit quality, and because the severity and duration of the unrealized losses were not significant, the Company considered these unrealized losses to be temporary at December 31, 2014.

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As of December 31, 2014 and June 30, 2014, the contractual maturities of available-for-sale securities were as follows:

	Years to Maturity		Total
	Less than One Year	One to Five Years	
December 31, 2014			
Available-for-sale	\$3,909,771	\$483,387	\$4,393,158

June 30, 2014			
Available-for-sale	\$4,434,575	\$476,318	\$4,910,893

Note 3. 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 4. 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 statements of comprehensive income for the three-month period ended December 31, 2014 and 2013, was \$13,029 and \$25,478, respectively, before income taxes. The related total deferred tax benefit was approximately \$1,371 and \$2,774 for the three-month period ended December 31, 2014 and 2013, respectively. Total stock-based compensation expense recognized in the statements of comprehensive income for the six-month period ended December 31, 2014 and 2013, was \$26,058 and \$52,243, respectively, before income taxes. The related total deferred tax benefit was approximately \$2,742 and \$5,779 for the six-month period ended December 31, 2014 and 2013, respectively. ASC 718 requires the tax benefits related to stock options exercised 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.

As of December 31, 2014, there was approximately \$34,742 of unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over the next 0.75 years. The total deferred tax benefit related to these awards is approximately \$3,653.

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 supersedes the Company's 2000 Stock Option Plan (the "2000 Plan"). Options covering 400,000 shares were authorized for issuance under the 2007 Plan, of which 190,100 have been granted and 124,325 are outstanding as of December 31, 2014. While no further grants of options may be made under the 2000 Plan, as of December 31, 2014, 27,330 options remain outstanding, vested and exercisable from the 2000 Plan.

ASC 718 requires the use of a valuation model to calculate the fair value of stock-based awards. The Company has elected to use the Black-Scholes option valuation model, which incorporates various assumptions including those for volatility, expected life and interest rates.

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There were no options awarded for the six months ended December 31, 2014. The table below outlines the weighted average assumptions that the Company used to calculate the fair value of the option award for the six months ended December 31, 2013.

	December 31, 2013
Dividend yield	3.67%
Expected stock price volatility	25.31%
Risk-free interest rate	1.23%
Expected option life (in years)	3.8 yrs
Weighted average fair value per share of options granted during the period	\$ 3.777

The Company pays dividends quarterly and paid a special cash dividend of \$1.00 per share in fiscal year 2014. The Company has not paid a special dividend in fiscal year 2015. Our Board of Directors assesses the Company's dividend policy periodically. There is no assurance, that the Board of Directors will either maintain the amount of the regular cash dividend or declare a special dividend during the fiscal year ending June 30, 2015 or any future years. 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 six months ended December 31, 2014:

	Employee Stock Options Plan			
	Number of Shares Subject To Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Weighted Average Aggregate Intrinsic Value
Balance at July 1, 2014	161,555	\$ 22.43	6.02	
Granted	—	—	—	
Exercised	(800 )	\$ 11.25	—	
Forfeited or expired	(9,100 )	\$ 25.22	—	
Outstanding at December 31, 2014	151,655	\$ 22.32	5.46	\$ 375,825
Vested or expected to vest at December 31, 2014	148,595	\$ 22.22	5.39	\$ 375,825
Exercisable at December 31, 2014	126,030	\$ 21.32	4.81	\$ 375,825

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 MKT on December 31, 2014 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 December 31, 2014. 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 six months

ended December 31, 2014 and 2013 was \$16,267 and \$68,729, respectively.

The following table summarizes changes in non-vested stock options during the six months ended December 31, 2014:

	Weighted Number of Shares Subject to Option	Average Grant Date Fair Value (per Option)
Non-Vested at July 1, 2014	25,975	\$ 3.777
Granted	—	—
Vested	—	—
Forfeited or expired	(350 )	\$ 3.777
Non-Vested at December 31, 2014	25,625	\$ 3.777

#### Note 5. 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 December 31, 2014 and 2013. 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



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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 will accrue the amount within the range that appears to be its best estimate of a possible outcome, which amounted to zero at December 31, 2014 and 2013.

## Note 6. Recently Issued Accounting Standards

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, "Revenue from Contracts with Customers" (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP.

The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our financial statements and have not yet determined the method by which we will adopt the standard in fiscal 2018.

## Note 7. 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 \$97,487 and \$153,236 for the three-month periods ended December 31, 2014 and 2013, respectively. ESOP compensation expense was \$208,678 and \$283,663 for the six-month periods ended December 31, 2014 and 2013, respectively.

The ESOP shares as of December 31, 2014 and 2013 were as follows:

	December 31, 2014	December 31, 2013
Allocated Shares	441,531	469,338
Committed-to-be-released shares	9,167	9,583
Unreleased shares	88,333	107,083
Total shares held by the ESOP	539,031	586,004
Fair value of unreleased shares	\$ 2,102,325	\$ 3,495,189

During the three and six months ended December 31, 2014 the Company repurchased 3,644 and 13,553 shares previously held in the ESOP for \$85,671 and \$320,504, respectively. During the three and six months ended

December 31, 2013 the Company did not repurchase any share previously held in the ESOP.

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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 MKT 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 and AS9100:2009 certified. 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. The Company received AS9100:2009 certification, a quality management system specific to the aerospace industry, in fiscal 2014. Major aerospace manufacturers and suppliers worldwide require compliance to AS9100 as a condition of doing business with them. Obtaining certification will allow the Company to maintain current business and provides an opportunity to expand the Company’s qualification to bid on more work in the aerospace industry.

Espey services include design and development to specification, build to print, design services, design studies, environmental testing services, metal fabrication, painting services, and development of automatic testing equipment. Espey 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.

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 certain countries the Company has external sales representatives to help solicit and coordinate foreign contracts. Espey is also 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. In addition, the Company directly pursues opportunities 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. Our business is not seasonal. The Company, as well as other companies engaged in supplying equipment for military applications are exposed to on-going associated risks including, without limitation, dependence on appropriations from the United States Government and the governments of foreign nations, program allocations, and the potential of governmental termination of orders for convenience.

The Company's backlog was approximately \$41.2 million at December 31, 2014, which includes \$26.2 million from two significant customers, compared to \$37.8 million at December 31, 2013, which included \$25.7 million from two significant customers. The backlog for the Company represents the estimated remaining sales value of work to be performed under firm contracts. This includes items that have been authorized and appropriated by Congress and/or funded by the customer. The unfunded portions of the backlog at December 31, 2014 and 2013 were \$2.3 million and zero, respectively, representing firm multi-year orders for which funding had not yet been appropriated by Congress or funded by our customer. While there is no guarantee that future budgets and appropriations will provide funding for a given program, management has included in unfunded backlog only those programs that it believes are likely to receive funding based on discussions with customers and program status.

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Declining federal defense spending continues to cause new incidents of competition in the industry. Based upon discussions during contract negotiations with our major customers, we believe that many of our competitors are aggressively investing in upfront product design costs and lowering profit margins as a strategic means of maintaining existing business and enhancing market share at the expense of short term profit. This change in the marketplace has put pressure on the pricing of our current products and will likely result in lower margins on new business and some of our legacy business. In order to compete effectively for new business, in some cases we invest in upfront design costs, thereby reducing initial profitability as a means of procuring new long-term programs. Accordingly, we have adjusted our pricing strategy in order to achieve a balance which enables us both to retain repeat programs while being more competitive in bidding on new programs. We continue to refine this strategy based upon our discussions with existing and prospective customers.

Moreover, engineering development contracts frequently have an element of uncertainty associated with the status of the applicable defense program, whether it will be approved for ultimate production and the timing of production, and whether the particular program will be funded by Congress. It is not uncommon for there to be a lapse of several years or more between engineering development work and production work. Or, as we have recently observed, production work may be delayed indefinitely or never occur.

New orders received in the first six months of fiscal 2015 were approximately \$16.8 million, as compared to \$9.3 million of new orders received in the first six months of fiscal 2014. Due to the uncertain timing of receipt of new orders, particularly large orders, period to period comparisons, including short-term fluctuations in backlog, are not necessarily indicative of business trends. We continue to quote a large volume of opportunities and are reviewing our cost components and cost structure to become more cost competitive in an attempt to replace business which had been anticipated but ultimately was either deferred indefinitely or lost.

While the sales backlog gives the Company a solid base of future sales, based upon the composition of the backlog and our anticipated schedule for the fulfillment of orders, management expects net sales in fiscal year 2015 to be less than net sales in fiscal year 2014. It is presently anticipated that a minimum of \$14 million of orders comprising the December 31, 2014 backlog will be filled during the fiscal year ending June 30, 2015. The minimum of \$14 million does not include any shipments, which may be made against orders subsequently received during the fiscal year ending June 30, 2015. The estimate of the December 31, 2014 backlog to be shipped in fiscal 2015 is subject to future events, which may cause the amount of the backlog actually shipped to differ from such estimate.

In addition to the backlog, the Company currently has outstanding opportunities representing approximately \$20 million in the aggregate for both repeat and new programs. The outstanding quotations encompass various new and previously manufactured standard and specialized military and industrial power electronics, power supplies, transformers as well as contract manufacturing. However, there can be no assurance that the Company will acquire any 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.

Management continues to evaluate our sales strategy including professional and technical resources necessary to keep pace with the changing market conditions and needs of our customers. Recently, the company revamped its sales organization and refocused its efforts to concentrate on our core competencies of designing and delivering to customer specification highly reliable power supplies, power magnetics and power distribution electronics for use in military and severe environment applications. In addition, we intend to design and produce some of our own products when we identify a potential need in the marketplace. We are starting to see some benefits from these organizational changes including the identification of new program opportunities including program awards in some instances.

Net sales to three significant customers represented 62.9% of the Company's total sales for the three-month period ended December 31, 2014 and net sales to two significant customers represented 47.3% of the Company's total sales

for the three-month period ended December 31, 2013. Net sales to two significant customers represented 50.7% and 59.2% of the Company's total sales for the six-month periods ended December 31, 2014 and 2013, respectively. This high concentration level with two customers presents significant risk. A loss of one of these customers or programs related to these customers could 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. Management continues to pursue 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.

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 \$200,000 for fiscal 2015, of which \$54,050 was expended through December 31, 2014. These expenditures are primarily being made to expand the production capability for transformers. Expectations are that working capital will be adequate to fund orders, regular quarterly dividend payments, and general operations of the business consistent with past practice. There is no guarantee that the Board of Directors will either maintain the amount of the regular cash dividend or declare a special dividend during the fiscal year ending June 30, 2015 or any future years.

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### Critical Accounting Policies and Estimates

Management believes our most critical accounting policies include revenue recognition and cost estimates to completion.

A significant portion of our business is comprised of engineering design and production contracts. Generally, revenues on these 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 decreased for the three months ended December 31, 2014 to \$5,697,083 as compared to \$6,569,641 for the same period in 2013. Net sales for the six months ended December 31, 2014 decreased to \$11,390,555 as compared to \$13,490,596 for the same period in 2013. The decrease in net sales for both the three and six months ended December 31, 2014 is primarily due to lower sales from engineering design contracts followed by a slight decline in electromechanical and transformer shipments.

For the three months ended December 31, 2014 and 2013 gross profits were \$2,258,735 and \$896,014, respectively. Gross profit as a percentage of sales was 39.6% and 13.7%, for the three months ended December 31, 2014 and 2013, respectively. For the six months ended December 31, 2014 and 2013, gross profits were \$4,068,814 and \$3,091,150, respectively. Gross profit as a percentage of sales was 35.7% and 22.9%, for the six months ended December 31, 2014 and 2013, 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 increase in gross profit in the three and six months ended December 31, 2014 was due to several factors. First, the Company yielded higher margins as a result of product mix as compared to the prior year where gross profits were negatively impacted by losses incurred on two engineering design contracts where the Company had been investing with an objective of developing future sales for follow-on production orders. Those programs were subsequently cancelled during the balance of fiscal 2014. In addition, the Company agreed to a final contract settlement in December 2014, relating to one of the cancelled programs, resulting in a reduction in cost of sales totaling \$560,000.

Selling, general and administrative expenses were \$633,177 for the three months ended December 31, 2014; a decrease of \$153,383, compared to the three months ended December 31, 2013. Selling, general and administrative expenses were \$1,231,379 for the six months ended December 31, 2014; a decrease of \$323,156 compared to the six months ended December 31, 2013. The decrease for the three and six months ended December 31, 2014 relates primarily to a reduction in salary expense due to reductions in the number of employees.

Interest and other income for the three months ended December 31, 2014 and 2013 was \$19,998 and \$41,071, respectively. Interest and other income for the six months ended December 31, 2014 and 2013 was \$37,648 and \$66,552, respectively. Interest and dividend income is a function of the level of investments and investment strategies which generally tend to be conservative.

The effective income tax rate at December 31, 2014 and 2013 was 25.9%. 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 December 31, 2014, was \$1,219,082 or \$0.54 per share both basic and diluted, respectively compared to \$111,152 or \$0.05 per share both basic and diluted, for the three months ended December 31, 2013. Net income for the six months ended December 31, 2014, was \$2,130,303 or \$0.94 and \$0.93 per share, basic and diluted, respectively compared to \$1,160,060 or \$0.52 and \$0.51 per share, basic and diluted, respectively, for the six months ended December 31, 2013. The increase in net income per share was mainly due to higher gross profits due to product mix and lower selling, general and administrative expenses, offset by lower sales.



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## 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. Management has available a \$3,000,000 line of credit to help fund further growth or working capital needs, if necessary, but does not anticipate the need for any borrowed funds in the foreseeable future.

The Company's working capital as of December 31, 2014 and 2013 was approximately \$28.1 million and \$27.3 million, respectively. During the three and six months ended December 31, 2014 the Company repurchased 3,644 and 13,553 shares of its common stock, respectively, from the Company's Employee Retirement Plan and Trust ("ESOP") for a purchase price of \$85,671 and \$320,504 respectively. During the three and six months ended December 31, 2013 the Company did not repurchase any shares of its common stock. Under existing authorizations from the Company's Board of Directors, as of December 31, 2014, management is authorized to purchase an additional \$1,385,744 million of Company stock.

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

	Six months Ended December 31,	
	2014	2013
Net cash provided by operating activities	\$ 1,636,421	\$ 2,837,149
Net cash provided by (used in) investing activities	461,511	(1,392,425 )
Net cash used in financing activities	(1,416,986 )	(3,116,033 )

Net cash provided by operating activities fluctuates between periods primarily as a result of differences in net income, provisions for income taxes, the timing of the collection of accounts receivable, purchase of inventory, level of sales and payment of accounts payable. Net cash provided by investing activities increased in the first six months of fiscal 2015 primarily due to a reduction in capital expenditures and the timing of the re-investment of matured securities. Net cash used in financing activities decreased primarily due to the reduction of dividends paid on common stock, related to a special dividend paid in the prior fiscal year, offset in part by 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.

During the six months ended December 31, 2014 and 2013, the Company expended \$54,050 and \$624,785, respectively, for plant improvements and new equipment. The Company has budgeted approximately \$200,000 for new equipment and plant improvements in fiscal 2015. Management anticipates that the funds required will be available from current operations.

The Company at certain times enters into standby letters of credit agreements with financial institutions primarily relating to the guarantee of future performance on certain contracts. The Company had no contingent liabilities on outstanding standby letters of credit agreements at each of December 31, 2014 and December 31, 2013.

**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.

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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.

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## 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 - None

(c) Securities Repurchased

## Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plan or Program (1)
December 1 to December 31, 2014	3,644	\$23.51	3,644	\$1,385,744

(1) Pursuant to a prior Board of Directors authorization, as of December 31, 2014 the Company can repurchase up to \$1,385,744 of its common stock pursuant to an ongoing plan.

## Item 3. Defaults Upon Senior Securities

None

## Item 4. Mine Safety Disclosures

Not applicable

## 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

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SIGNATURES

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

ESPEY MFG. & ELECTRONICS CORP.

/s/Patrick Enright Jr.  
Patrick Enright Jr.  
President and Chief Executive Officer

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

February 12, 2015

Date