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ESPEY MFG & ELECTRONICS CORP
Form 10QSB
February 13, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-QSB

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

For the Quarterly Period Ended December 31, 2005

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

For the transition period from _____ to _____

Commission File Number I-4383

ESPEY MFG. & ELECTRONICS CORP.

(Exact name of registrant as specified in charter)

NEW YORK

14-1387171

(State of Incorporation)

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

233 Ballston Avenue, Saratoga Springs, New York 12866

(Address of principal executive offices)

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

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

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

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

| Class ----- | Outstanding at February 13, 2006 ----- |
|-----------------------------------|---|
| Common stock, \$.33-1/3 par value | 2,296,762 shares |

Transitional Small Business Disclosure Format YES NO

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

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PART I: FINANCIAL INFORMATION

ESPEY MFG. & ELECTRONICS CORP.
Balance Sheet (Unaudited)
December 31, 2005

December 31,
2005

ASSETS:

| | |
|---------------------------|--------------|
| Cash and cash equivalents | \$ 7,457,105 |
| Short term investments | 4,032,000 |

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| | |
|---|---------------|
| Trade accounts receivable, net | 3,556,018 |
| Other receivables | 8,658 |
| Inventories: | |
| Raw materials and supplies | 1,783,852 |
| Work-in-process | 2,443,499 |
| Costs relating to contracts in process, net of advance payments of \$344,578 at December 31, 2005 | 6,973,947 |
| | ----- |
| Total inventories | 11,201,298 |
| Deferred income taxes | 135,997 |
| Prepaid expenses and other current assets | 402,250 |
| | ----- |
| Total current assets | 26,793,326 |
| | ----- |
| Property, plant and equipment, net | 2,946,194 |
| | ----- |
| Total assets | \$ 29,739,520 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY:

| | |
|---|---------------|
| Accounts payable | \$ 843,467 |
| Accrued expenses: | |
| Salaries, wages and commissions | 79,302 |
| Vacation | 441,105 |
| ESOP payable | 178,551 |
| Other | 67,820 |
| Payroll and other taxes withheld and accrued | 42,091 |
| Income taxes payable | 77,243 |
| | ----- |
| Total current liabilities | 1,729,579 |
| | ----- |
| Deferred income taxes | 263,057 |
| | ----- |
| Total liabilities | 1,992,636 |
| | ----- |
| Common stock, par value \$.33-1/3 per share. | |
| Authorized 10,000,000 shares; issued | |
| 3,029,874 shares on December 31, 2005 | |
| Outstanding 2,296,762 on December 31, 2005 | 1,009,958 |
| Capital in excess of par value | 12,424,236 |
| Retained earnings | 24,945,747 |
| Less: Cost of 300,000 Unearned ESOP Shares on December 31, 2005 | (4,335,000) |
| Cost of 733,112 Treasury shares on December 31, 2005 | (6,298,057) |
| | ----- |
| Total stockholders' equity | 27,746,884 |
| | ----- |
| | |
| Total liabilities and stockholders' equity | \$ 29,739,520 |
| | ===== |

See accompanying notes to the financial statements.

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ESPEY MFG. & ELECTRONICS CORP.
 Statements of Income (Unaudited)
 Three and Six Months Ended December 31, 2005 and 2004

| | Three Months | | Six Months | |
|--|--------------|--------------|--------------|--------------|
| | 2005 | 2004 | 2005 | 2004 |
| Net sales | \$ 5,056,083 | \$ 4,896,741 | \$ 9,616,657 | \$ 9,616,657 |
| Cost of sales | 4,108,723 | 4,124,354 | 7,789,007 | 8,124,354 |
| Gross profit | 947,360 | 772,387 | 1,827,650 | 1,492,303 |
| Selling, general and administrative expenses | 666,440 | 580,538 | 1,336,159 | 1,336,159 |
| Operating income | 280,920 | 191,849 | 491,491 | 156,144 |
| Other income (expense) | | | | |
| Interest and dividend income | 110,976 | 43,618 | 209,910 | 209,910 |
| Other | (5,614) | 3,150 | (8,437) | (8,437) |
| | 105,362 | 46,768 | 201,473 | 201,473 |
| Income before income taxes | 386,282 | 238,617 | 692,964 | 357,617 |
| Provision for income taxes | 112,022 | 71,585 | 200,960 | 200,960 |
| Net income | \$ 274,260 | \$ 167,032 | \$ 492,004 | \$ 156,657 |
| Net income per share: | | | | |
| Basic | \$ 0.14 | \$ 0.08 | \$ 0.24 | \$ 0.14 |
| Diluted | \$ 0.13 | \$ 0.08 | \$ 0.24 | \$ 0.13 |
| Weighted average number of shares outstanding: | | | | |
| Basic | 2,010,791 | 2,022,756 | 2,010,779 | 2,010,779 |
| Diluted | 2,049,020 | 2,049,070 | 2,050,590 | 2,049,070 |
| Dividends per share: | \$ 0.0875 | \$ 0.075 | \$ 0.1625 | \$ 0.1625 |

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

See accompanying notes to the financial statements.

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ESPEY MFG. & ELECTRONICS CORP.
 Statements of Cash Flows (Unaudited)
 Six Months Ended December 31, 2005 and 2004

| | December 31 | |
|---|-------------|-------|
| | 2005 | 2004 |
| | ----- | ----- |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 492,004 | \$ |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 278,391 | |
| ESOP compensation expense | 227,301 | |
| Loss on disposal of assets | 18,660 | |
| Deferred income tax | (35,000) | |
| Changes in assets and liabilities: | | |
| Increase in trade receivables, net | (562,778) | |
| Increase in other receivables | (5,485) | |
| (Increase) decrease in inventories | (833,746) | |
| (Increase) decrease in prepaid expenses and other current assets | (66,255) | |
| Increase in accounts payable | 464,696 | |
| Increase in accrued salaries, wages and commissions | 17,024 | |
| Increase in accrued employees' insurance costs | -- | |
| Decrease in vacation accrual | (56,910) | |
| Increase in other accrued expenses | 14,037 | |
| Increase in payroll & other taxes withheld and accrued | 6,114 | |
| Decrease in income taxes payable | (234,885) | |
| Decrease in ESOP payable | (48,750) | |
| | ----- | ----- |
| Net cash (used in) provided by operating activities | (325,582) | |
| | ----- | ----- |
| Cash Flows From Investing Activities: | | |
| Unearned ESOP Shares | (4,335,000) | |
| Additions to property, plant & equipment | (258,908) | |
| Proceeds on sale of assets, net | 500 | |
| Purchase of short term investments | (3,648,000) | |
| Maturity of short term investments | 2,688,000 | |
| | ----- | ----- |
| Net cash used in investing activities | (5,553,408) | |
| | ----- | ----- |
| Cash Flows From Financing Activities: | | |
| Sale of treasury stock | 4,396,424 | |
| Dividends on common stock | (325,832) | |
| Purchase of treasury stock | (679,809) | |
| Proceeds from exercise of stock options | 141,805 | |
| | ----- | ----- |
| Net cash provided by (used in) financing activities | 3,532,588 | |
| | ----- | ----- |
| Decrease in cash and cash equivalents | (2,346,402) | |
| Cash and cash equivalents, beginning of period | 9,803,507 | 1 |
| | ----- | ----- |
| Cash and cash equivalents, end of period | 7,457,105 | 1 |

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Supplemental disclosures of cash flow information:

| | | |
|-------------------|------------|----|
| Income Taxes Paid | \$ 470,845 | \$ |
|-------------------|------------|----|

Non-cash investing and financing activities:

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

See accompanying notes to the financial statements.

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

Note 1. Basis of Presentation

In the opinion of management the accompanying unaudited financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary for a fair presentation of the results for such periods. The results for any interim period are not necessarily indicative of the results to be expected for the full fiscal year. Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the Company's most recent audited financial statements included in its 2005 Form 10-K.

Note 2. Net Income per Share

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

Note 3. Stock Based Compensation

The Company has elected to account for its stock-based compensation plans under the intrinsic value-based method of accounting as permitted by SFAS No. 123 and as prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations including FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation - An Interpretation of APB No. 25," in accounting for its fixed stock option plan. Under this method, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS No. 123, to stock-based employee compensation.

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| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|------------|----------------------------------|------------|
| | 2005 | 2004 | 2005 | 2004 |
| Net income as reported | \$ 274,260 | \$ 167,032 | \$ 492,004 | \$ 227,616 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (20,926) | (9,997) | (25,784) | (18,374) |
| Pro forma net income | \$ 253,334 | \$ 157,035 | \$ 466,220 | \$ 209,242 |
| Net Income per share: | | | | |
| Basic-as reported | \$.14 | \$.08 | \$.24 | \$.11 |
| Basic-pro forma | \$.13 | \$.08 | \$.23 | \$.10 |
| Diluted-as reported | \$.13 | \$.08 | \$.24 | \$.11 |
| Diluted-pro forma | \$.12 | \$.08 | \$.23 | \$.10 |

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Note 4. Commitments and Contingencies

The Company has entered 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 \$19,650 at December 31, 2005. The Company does not expect to fund any of the amounts under the standby letters of credit. As a government contractor, the Company is continually subject to audit by various agencies of the U.S. Government to determine compliance with various procurement laws and regulations. As a result of such audits and as part of normal business operations of the Company, various claims and charges can be asserted against the Company. It is not possible at this time to predict the outcome of any such actions. However, management is of the opinion that it has or would have good defenses against such actions and believes that none of these matters will have a material effect on the consolidated financial position, results of operations or cash flows of the Company.

Note 5. Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123R, "Share Based Payment." SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R was originally effective for interim and annual periods beginning after December 15, 2005. The effective date has been delayed by the SEC until annual periods beginning after December 15, 2005. The SFAS No. 123R is not expected to have a material impact on the Company's results of operations and financial condition.

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In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets - Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions." SFAS No. 153 requires that exchanges should be recorded and measured at the fair value of the assets exchanged, with certain exceptions. SFAS No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a significant impact on the Company's results of operations or financial position.

In June 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections", a replacement of APB Opinion No. 20, "Accounting Changes", and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 changes the requirements of the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods' financial statements, unless it is impractical to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any of the existing accounting pronouncements. We do not believe adoption of SFAS No. 154 will have a material effect on our consolidated financial position, results of operations or cash flows.

Note 6. Employee Stock Ownership Plan

The Company sponsors a leveraged employee stock ownership plan (the "ESOP") that covers all nonunion employees who work 1,000 or more hours per year and are employed on June 30. Prior to July 15, 2005, the ESOP owned 230,120 shares, all of which were allocated to employees. On July 15, 2005, pursuant to a Stock Purchase Agreement dated as of such date, the Company, by selling 150,000 shares of its common stock, par value \$0.33 1/3 per share, to the Espey Mfg. & Electronics Corp. Employee Stock Ownership Plan Trust, provided more shares to be allocated to employees for services rendered over the next 15 years. The ESOP paid \$28.90 per share, for an aggregate purchase price of \$4,335,000. The determination of the purchase price was based on a fairness opinion obtained by an independent valuation firm. The ESOP borrowed from the Corporation an amount equal to the purchase price. The loan will be repaid in fifteen (15) equal annual installments of principal and the unpaid balance will bear interest at a fixed rate of 6.25% per annum, the "prime rate" as quoted in The Wall Street Journal on the date of closing.

The Board of Directors of the Company had approved a purchase price per share equal to a 5% discount on the average trading price of the Company's common stock on the American Stock Exchange on the date before closing, but in no event greater than the fair market value as determined by an independent valuation firm retained by the

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ESOP. The average trading price of the Company's common stock on the American Stock Exchange on July 14, 2005 was \$30.72.

In making the sale, the Company relied on the exemption from registration under Section 4(2) of the Securities Act of 1933, as amended, because the shares sold were offered only to the ESOP.

After giving effect to the transaction the ESOP owned 380,120 shares of the Company's 1,158,294 outstanding shares of common stock as of July 15, 2005.

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The Company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends on unallocated shares received by the ESOP. All dividends on unallocated shares received by the ESOP are used to pay debt service. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings. As the debt is repaid, shares are released and allocated to active employees, based on the proportion of debt service paid in the year. The Company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the shares purchased by the ESOP are reported as Unearned ESOP Shares in the statement of financial position. As shares are released or committed-to-be-released, the Company reports compensation expense equal to the current average market price of the shares, and the shares become outstanding for earnings-per-share (EPS) computations. ESOP compensation expense was \$120,900 for the quarter ended December 31, 2005 and \$227,301 for the six-month period ending December 31, 2005. The ESOP shares as of December 31 (after the stock split described in note 7) were as follows:

| | |
|--|--------------|
| Allocated Shares | 424,244 |
| Committed-to-be-released shares | 12,916 |
| Unreleased shares | 287,084 |
| | ----- |
| Total shares held by the ESOP | 724,244 |
| | ===== |
| Fair value of unreleased shares at December 31, 2005 | \$ 5,282,346 |
| | ===== |

Note 7. Stock Split

On December 30, 2005, the Company effected a one-for-one stock split in the form of a dividend of one share of common stock for each share of common stock outstanding. The Company also allocated to treasury an additional share for each share being held as a treasury share. All references to the number of common shares, shares related to the Company's stock option plan, as well as per share data in the accompanying financial statements, have been adjusted to reflect the stock split on a retroactive basis with the exception of the details describing the Company's ESOP transaction which became executed on July 15, 2005 described in note 6 and "Other Matters". As a result of the stock split, common stock was increased and retained earnings was decreased by \$504,979.

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

Overview

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

Business is solicited from large industrial manufacturers and defense companies,

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

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

Management is optimistic about the future of the Company. In the first half of fiscal 2006, the Company received approximately \$20.6 million in new orders. These orders include both follow-on production quantities for mature products, and engineering development orders which will enable the Company to utilize its engineering expertise in developing new customer specific products. Some of these products, once developed, will be produced in the Company's manufacturing facility and are expected to provide large production order quantities over several years. These orders are in line with the Company's strategy of getting involved in long-term high quantity military and industrial products.

The sales backlog of approximately \$42.7 million at December 31, 2005 gives the Company a solid base of future sales and, therefore, management expects an increase in sales during fiscal 2006 as compared to fiscal 2005. In addition to the backlog, the Company currently has outstanding quotations representing in excess of \$27.9 million in the aggregate for both repeat and new programs. Many potential orders are currently being discussed and negotiated with our 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.

The total backlog for the Company of \$42.7 million at December 31, 2005, up \$28.6 million over December 31, 2004, represents the estimated remaining sales value of work to be performed under firm contracts. The funded portion of this backlog at December 31, 2005 is approximately \$34.1 million. This includes items that have been authorized and appropriated by Congress and/or funded by the customer. The unfunded backlog is approximately \$8.6 million and represents firm multi-year orders for which funding has not yet been appropriated by Congress. While there is no guarantee that future budgets and appropriations will provide funding for a given program, management has included in unfunded backlog only those programs that it believes are likely to receive funding.

The unfunded backlog at December 31, 2004 was zero. The backlog at December 31,

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2005, as discussed above, includes significant orders for military and industrial power supplies, and contracts to manufacture certain customer products in accordance with pre-engineered requirements.

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

Critical Accounting Policies and Estimates

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

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

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

Results of Operations

Net sales for the three months ended December 31, 2005 were \$5,056,083 as compared to \$4,896,741 for the same period in 2004, representing a 3.3% increase. Net sales for the six months ended December 31, 2005 were \$9,616,657 as compared to \$9,627,068 for the same period in 2004. The Company's sales for the three month and six month period ended December 31, 2005 remained relatively flat compared to the prior year. Generally, this can be attributed to the contract specific nature of the Company's business and the long-term nature of these contracts. The increase in backlog that occurred during the prior year should begin to be reflected in net sales in the near future. New orders received in the first half of fiscal 2006 were approximately \$20.6 million compared to approximately \$8.3 million in the first half of fiscal 2005.

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

For the three months ended December 31, 2005 and 2004 gross profits were \$947,360 and \$772,387, respectively. Gross profit as a percentage of sales was 18.7% and 15.8%, for the three months ended December 31, 2005 and 2004, respectively. For the six months ended December 31, 2005 and 2004 gross profits were \$1,827,650 and \$1,421,529, respectively. Gross profit as a percentage of sales was 19.0% and 14.8%, for the six months ended December 31, 2005 and 2004, respectively. The improved gross profit percentage in the three and six months

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ended December 31, 2005, relates to favorable product mix, offset partially by higher ESOP contribution expense and higher energy costs. ESOP contribution expense included in cost of sales was \$96,720 for the three months ended December 31, 2005, and \$181,840 for the six months ended December 31, 2005, and \$0 for both comparable periods of the prior year (see note 6 to the financial statements). Management continues to evaluate the Company's workforce to ensure that production and overall execution of the backlog orders and additional anticipated orders are successfully performed. Employment at December 31, 2005 was 175 people compared to 171 people at December 31, 2004.

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Selling, general and administrative expenses were \$666,440 for the three months ended December 31, 2005; an increase of \$85,902 compared to the three months ended December 31, 2004. Selling, general and administrative expenses were \$1,336,159 for the six months ended December 31, 2005; an increase of \$154,942 compared to the six months ended December 31, 2004. The increase is primarily due to an increase in the sales force and ESOP contribution expense, offset partially by a decrease in professional fees.

Other income for three and six months ended December 31, 2005 increased as compared to the three months ended December 31, 2004 due to increased interest income on the Company's cash equivalents and short-term investments due to higher interest rates. The Company does not believe that there is a significant risk associated with its investment policy, since at December 31, 2005 all of the investments are primarily represented by short-term liquid investments including certificates of deposit and money market accounts.

The effective income tax rate at December 31, 2005 and 2004 was 29.0% and 30.0%, respectively. The effective tax rate is less than the statutory tax rate mainly due to the foreign exportation benefit the Company receives on its international sales, the Qualified Production Activities benefit, and the benefit derived from the ESOP dividends paid on allocated shares.

Net income for the three months ended December 31, 2005, was \$274,260 or \$.14 and \$.13 per share, basic and diluted, respectively, compared to \$167,032 or \$.08 per share, both basic and diluted, for the three months ended December 31, 2004. Net income for the six months ended December 31, 2005, was \$492,004 or \$.24 per share, both basic and diluted, compared to \$227,616 or \$.11 per share, both basic and diluted, for the six months ended December 31, 2004. The increase in net income per share was due to improved gross profit as a percentage of sales, offset partially by the increase in selling, general and administrative expenses.

Liquidity and Capital Resources

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

The Company's working capital as of December 31, 2005 was approximately \$25.1 million. During the three months ended December 31, 2005 and 2004 the Company repurchased 14,462, and 0 shares, respectively, of its common stock from the Company's Employee Retirement Plan and Trust ("ESOP"), for a total purchase price of \$262,125 and \$0, respectively. During the six months ended December 31, 2005 and 2004 the Company repurchased 38,746 and 8,028 shares, respectively, of

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its common stock for a total purchase price of \$679,809 and \$90,315, respectively. Under existing authorizations from the Company's Board of Directors, as of December 31, 2005, management is authorized to purchase an additional \$737,876 million of Company stock.

| | Six Months Ended December 31, | |
|---|-------------------------------|-------------|
| | 2005 | 2004 |
| | ----- | ----- |
| Net cash (used in) provided by operating activities | \$ (325,582) | \$1,283,818 |
| Net cash used in investing activities | (5,553,408) | (998,716) |
| Net cash provided by (used in) financing activities | 3,532,588 | (378,146) |

Net cash provided by operating activities fluctuates between periods primarily as a result of differences in net income, the timing of the collection of accounts receivable, purchase of inventory, level of sales and payment of accounts payable. Net cash used in investing activities increased in the first half of fiscal 2006 due to the purchase of short-term investments and the ESOP transaction described in note 6. The increase in cash provided by financing activities is due primarily to the sale of treasury shares to the ESOP in the first half of fiscal 2006.

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.

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During the six months ended December 31, 2005 and 2004, the Company expended \$258,908 and \$230,716, respectively, for plant improvements and new equipment. The Company has budgeted approximately \$500,000 for new equipment and plant improvements in fiscal 2006. Management presently anticipates that the funds required will be available from current operations.

The Company has entered 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 \$19,650 at December 31, 2005. The Company does not expect to fund any of the amounts under the standby letters of credit.

Other Matters

On July 15, 2005, pursuant to a Stock Purchase Agreement dated as of such date, the Company sold 150,000 shares of its common stock, par value \$0.33 1/3 per share, to the Espey Mfg. & Electronics Corp. Employee Stock Ownership Plan Trust (the "ESOP"). The ESOP paid \$28.90 per share, for an aggregate purchase price of \$4,335,000. The determination of the purchase price was based on a fairness opinion obtained by an independent valuation firm. The ESOP borrowed from the Corporation an amount equal to the purchase price. The loan will be repaid in fifteen (15) equal annual installments of principal and the unpaid balance will bear interest at a fixed rate of 6.25% per annum, the "prime rate" as quoted in The Wall Street Journal on the date of closing.

The Board of Directors of the Company approved a purchase price per share equal to a 5% discount on the average trading price of the Company's common stock on the American Stock Exchange on the date before closing, but in no event greater than the fair market value as determined by an independent valuation firm retained by the ESOP. The average trading price of the Company's common stock on

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the American Stock Exchange on July 14, 2005 was \$30.72.

In making the sale, the Company relied on the exemption from registration under Section 4(2) of the Securities Act of 1933, as amended, because the shares sold were offered only to the ESOP.

After giving effect to the transaction the ESOP owned 380,120 shares of the Company's 1,158,294 outstanding shares of common stock as of July 15, 2005. As of December 31, 2005, there were 424,244 shares (after giving effect to the one-for-one stock dividend) allocated to participants.

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

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

Item 3. Controls and Procedures

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

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

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PART II: Other Information and Signatures

Item 1. Legal Proceedings

None

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

(a) Securities Sold - For the three and six month periods ended December 31, 2005, 8,800 and 15,400 stock options were exercised under the Company's existing stock option plan, respectively. In addition to the stock option shares, the Company sold 3,520 shares to the ESOP for the three and six month periods ended December 31, 2005. The securities were sold for cash and the sales were made without registration under the Securities Act in reliance upon the exemption from registration afforded under Section 4(2) of the Securities Act of 1933. Proceeds were used for general working capital purposes.

(c) Securities Repurchased

Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan or Program | Maximum (or Approximate) Dollar Value of Shares that May Be Purchased Under the Program |
|---------------------------------|----------------------------------|------------------------------|--|---|
| December 1 to December 31, 2005 | 14,462 | \$18.13 | 14,462 | \$320 |

(1) Pursuant to a prior Board of Directors authorization, as of December 31, 2005 the Company can repurchase up to \$737,876 of its common stock pursuant to an ongoing plan.

Item 3 Defaults on Senior Securities

None

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

(a) The Company's Annual Meeting of Shareholders (the "Annual Meeting") was held on November 18, 2005.

(b) Barry Pinsley was re-elected as a Class B director to serve for a two-year term. Paul J. Corr and Michael W. Wool were re-elected as Class C directors each to serve for a three-year term. Continuing as directors after the Annual Meeting were:

Class A (term expiring 2006): Howard Pinsley
Alvin O. Sabo
Carl Helmetag

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Class B (term expiring 2007): Barry Pinsley
Seymour Saslow

Class C (term expiring 2008): Paul J. Corr
Michael W. Wool

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(c) The following matters were voted upon at the annual meeting:

The election of one Class B director. The votes were cast as follows:

| Nominee: | Voted For: | Voted Against or Withheld: | Broker Non-Votes: |
|---------------|------------|----------------------------|-------------------|
| ----- | ----- | ----- | ----- |
| Barry Pinsley | 1,000,091 | 129,637 | 0 |

The election of two Class C directors. The votes were cast as follows:

| Nominee: | Voted For: | Voted Against or Withheld: | Broker Non-Votes: |
|-----------------|------------|----------------------------|-------------------|
| ----- | ----- | ----- | ----- |
| Paul J. Corr | 1,107,441 | 22,287 | 0 |
| Michael W. Wool | 973,791 | 155,937 | 0 |

Ratification of Rotenberg & Company LLP, as independent auditors for the Corporation for the fiscal year ending June 30, 2006. The votes were cast as follows:

| | |
|------------------|-----------|
| Shares IN FAVOR | 1,125,750 |
| Shares AGAINST | 100 |
| ABSTENTIONS | 3,878 |
| Broker NON-VOTES | 0 |

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of the Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of the Principal Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of the Principal Financial Officer

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pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on form 8-K

Form 8-K filed October 7, 2005 updating the Company's description of its Common Stock.

Form 8-K filed October 25, 2005, announcing the dismissal of KPMG LLP as the Company's independent registered public accounting firm. Also announcing the engagement of Rotenberg & Company LLP as the Company's independent public accountants.

Form 8-K filed November 21, 2005, announcing the Company's Board of Directors declaration of an increased cash dividend and a one-for-one stock split.

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S I G N A T U R E S

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

ESPEY MFG. & ELECTRONICS CORP.

/s/ Howard Pinsley

Howard Pinsley, President and
Chief Executive Officer

/s/ David O'Neil

David O'Neil, Treasurer and
Principal Financial Officer

February 13, 2006

Date

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