ESPEY MFG & ELECTRONICS CORP
Form 10-K
September 17, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the fiscal year ended June 30, 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)

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

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

Securities registered pursuant to Section 12 (g) of the Act

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

£ Yes S No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

£ Yes S No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

S Yes £ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.

S Yes £ No

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

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

£ Large accelerated filer £ Accelerated filer £ Non-accelerated filer S Smaller reporting company
Indicate by check mark whether the registrant is a shell company.

£ Yes S No

The aggregate market value of the voting stock held by non-affiliates of the registrant was $51,915,281 based upon the closing sale price of $32.64 on the NYSE MKT on December 31, 2013.

At September 16, 2014, there were 2,368,910 shares outstanding of the registrant's Common stock, $.33-1/3 par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement relating to the 2014 Annual Meeting of Shareholders, to be filed with the Securities and Exchange Commission, are incorporated by reference in Part III, Items 10 through 14 on Form 10-K as indicated herein.

Forward-Looking Statements

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

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

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

PART I

Item 1. Business
General

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

In the fiscal years ended June 30, 2014 and 2013, the Company's total sales were $27,136,919 and $34,298,210, respectively. Sales to three customers accounted for 31%, 16% and 12% of total sales in 2014. Sales to three customers accounted for 33%, 18% and 12% of total sales in 2013. A loss of a significant customer would negatively impact the financial performance of the Company.

Export sales in 2014 and 2013 were approximately $3,030,000 and $2,671,000, respectively. This increase is primarily due to the shipment of transmitter components to a specific customer.

Sources of Raw Materials

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

Sales Backlog

At September 4, 2014, the Company's backlog was approximately $34 million. The total backlog at June 30, 2014 was approximately $35.7 million compared to approximately $42.1 million at June 30, 2013. The Company’s total backlog represents the estimated remaining sales value of work to be performed under firm contracts. The funded portion of this backlog at June 30, 2014 is approximately $33.4 million. This includes items that have been authorized and appropriated by Congress and/or funded by the customer. The unfunded backlog is approximately $2.3 million and represents firm multi-year orders for which funding has 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. The unfunded backlog at June 30, 2013 was $114,000. The Company's backlog and risks associated with government contracts is discussed in greater detail in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 7 below.

It is presently anticipated that a minimum of $18 million of orders comprising the June 30, 2014 backlog will be filled during the fiscal year ending June 30, 2015. The minimum of $18 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 June 30, 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.

Our backlog has declined due to several factors. First, the unresolved process for addressing the U.S.'s fiscal imbalances is a risk, not unique to Espey, and is common to all defense contractors. The Congressional sequestration and subsequent budget compromise has established a level of uncertainty associated with large-scale defense cuts and has caused delays in program management including the processing of new orders and request for proposals associated with new procurement.

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.

In addition to factors affecting the defense industry generally, recently, we have experienced negative developments involving two specific engineering programs which we believed had the potential to result in significant sales for the Company. These programs have been cancelled by the respective customers, resulting in a reduction of the sales backlog by approximately $2.6 million. Further discussion associated with the cancelled contracts is discussed in greater detail in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 7 below.

Another factor contributing to the decline of the backlog has been our inability, thus far, to convert marketing efforts to potential new customers into awards of business.

Marketing and Competition

The Company markets its products primarily through its own direct sales organization. Business is solicited from large industrial manufacturers and defense companies, the government of the United States, foreign governments and major foreign electronic equipment companies. In 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. 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.

Our business is not seasonal. However, the concentration of our business in equipment for military applications and our customer concentrations expose us 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.

Declining federal defense spending has caused 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 market place 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, we may similarly need to 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 as we move forward.

Research and Development

The Company's expenditures for research and development were approximately $93,588 and $60,597 in fiscal 2014 and 2013, respectively. Some of the Company's engineers and technicians spend varying degrees of time on either development of new products or improvements of existing products. A majority of these expenditures relate to research that is required by Espey engineers to support a request for a quotation from a customer having a product-specific custom need usually associated with stringent size and weight requirements.

Employees

The Company had 145 employees as of September 11, 2014. Approximately 40% of these employees are represented by the International Brotherhood of Electrical Workers Local #1799. A new collective bargaining agreement was approved in July 2012. The three-year agreement expires on June 30, 2015. Relations with the Union are considered good.

Government Regulations

Compliance with federal, state and local laws regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, did not in fiscal year 2014, and the Company believes will not in fiscal year 2015, have a material effect upon the capital expenditures, net income, or competitive position of the Company.

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

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

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

U.S. Government Defense Contracts and Subcontracts

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

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

Item 2. Property

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

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

Item 3. Legal Proceedings
None

Item 4. Mine Safety Disclosures
Not applicable

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PART II

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

Price Range of Common Stock

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

2014	High	Low
First Quarter	$28.88	$25.35
Second Quarter	33.89	28.60
Third Quarter	32.64	26.45
Fourth Quarter	28.50	22.44
2013		
First Quarter	$31.00	$22.03
Second Quarter	27.98	22.87
Third Quarter	26.94	24.26
Fourth Quarter	26.49	24.09

Holders

The approximate number of holders of record of the common stock was 88 on September 9, 2014 according to records of the Company's transfer agent. Included in this number are shares held in "nominee" or "street" name and, therefore, the number of beneficial owners of the common stock is believed to be substantially in excess of the foregoing number.

Dividends

The Company paid cash dividends on common stock of $2.00 per share for the fiscal year ended June 30, 2014 and $1.975 per share for the fiscal year ended June 30, 2013, which included a special dividend of $1.00 per share during each fiscal year. The Board of Directors has authorized the payment of a fiscal 2015 first quarter dividend of $.25 payable September 30, 2014 to shareholders of record on September 25, 2014. 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 any future years.

During fiscal 2014, the Company sold common stock to certain employees and directors as they exercised existing stock options granted under a shareholder approved plan. During the year, 23,420 shares were sold at prices that ranged from $15.95 a share to $25.10 a share. The securities were sold for cash. Proceeds are used for general working capital purposes.

The Company did not make any open market purchases of equity securities in the fiscal 2014 fourth quarter.

The following table sets forth information as of June 30, 2014 with respect to compensation plans under which equity securities of the Company may be issued.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of Securities remaining available for future issuance under equity compensation plan (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	161,555	$22.43	226,925
Equity compensation plans not approved by security holders	--		--
Total	161,555		226,925

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

Management expects revenues in fiscal 2015 to be less than fiscal year 2014 revenues. Expectations are for product mix and margins to remain favorable for fiscal year 2015. During fiscal 2014 new orders received by the Company were approximately $21 million. The total backlog at June 30, 3014 was approximately $35.7 million. It is presently anticipated that a minimum of $18 million of orders comprising the June 30, 2014 backlog will be filled during the fiscal year ending June 30, 2015. The minimum of $18 million does not include any shipments, which may be made against orders subsequently received during the fiscal year ending June 30, 2015. See discussions below for further detail on the customer mix included in the backlog.

In addition to the backlog, the Company currently has outstanding opportunities representing in excess of $21 million in the aggregate for both repeat and new programs. 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 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.

Revenues, backlog and outstanding opportunities have declined and we believe may continue to trend down in the foreseeable future due to several ongoing factors discussed in detail in the Sales Backlog and Marketing and Competition sections contained in Item 1 above. Management continues to evaluate our sales strategy including the professional and technical resources necessary to keep pace with the changing market conditions and needs of our customers. The Company has added to and re-aligned current sales and engineering resources, in order to focus on penetrating opportunities with new and existing customers. The Company continues quoting new customers for programs of varying sizes.

Three significant customers represented 59% and 63% of the Company’s total sales in fiscal 2014 and 2013, respectively. These sales are in connection with multiyear programs in which the Company is a significant subcontractor. The June 30, 2014 backlog of $35.7 million includes orders from two customers that represent 50% and 16% of the total backlog. 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. Expectations are that the working capital will be required to fund orders, dividend payments, and general operations of the business. From time to time, management along with the Mergers and Acquisitions Committee of the Board of Directors examine opportunities involving acquisitions or other strategic options, including buying certain products or product lines. The criteria for consideration are synergies with the Company’s existing product base and accretion to earnings.

Results of Operations

Net sales for fiscal years ended June 30, 2014 and 2013, were $27,136,919 and $34,298,210, respectively, a 21% decrease. This decrease can be attributed to the contract specific nature of the Company’s business and the timing of deliveries on these contracts. More specifically, power supply and transformer sales decreased by $6.5 million and $3 million, respectively, offset by an increase in electro-mechanical and spare parts shipments of $2.5 million.

For the fiscal years ended June 30, 2014 and 2013 gross profits were $4,531,246 and $10,699,569, respectively. Gross profit as a percentage of sales decreased to 16.7% for fiscal 2014, down from 31.2% in fiscal 2013. The primary factor in determining gross profit and net income is product mix. The gross profits on mature products and build to print contracts are higher as compared to products that are still in the engineering development stage or in the early stages of production. In any given accounting period the mix of product shipments between higher margin mature programs and less mature programs including loss contracts, has a significant impact on gross profit and net income. The decrease in gross profit in fiscal 2014 compared to fiscal 2013 was primarily driven by two factors. These factors were a sales decrease caused by a declining backlog, and losses incurred on two engineering design programs in which the Company had been investing with the objective of developing future sales for follow-on production orders. As to both of these programs, we are either certain or believe that no sales will materialize during the next several years.

In one instance, we experienced engineering problems (in part attributable to Espey) which caused the customer to look for alternative solutions. The impact of the program cancellation on total gross profit for fiscal 2014 was a decrease by $263,000. In a separate program, we encountered engineering problems in the final stages of a significant contract for three separate parts for a military ground combat vehicle. The program required complex electrical designs, and we were unsuccessful in delivering all required compliant prototypes to the customer by the agreed upon contract dates. Our customer would not give us any more time to complete these units as they were required to close out the prime contract by the U.S. Government. The program itself posed increased risk related to follow-on production orders as it was announced during fiscal 2014 that production funding for this vehicle was cut by the Department of Defense with no certainty as to whether the program would be revived and funded at a future date. The impact of the program cancellation on gross profit for fiscal 2014 was a decrease of $3.6 million. Losses affecting gross profit were favorably offset by the reduction of a contract audit reserve of $319,000.

Selling, general and administrative expenses were $3,214,050 for the fiscal year ended June 30, 2014, an increase of $296,910, or 10% as compared to the prior year. The increase for fiscal 2014 relates primarily to severance costs incurred for terminated employees and an increase in salary expense associated with new personnel hired during fiscal 2014.

Employment of full time equivalents at June 30, 2014 was 150 people compared with 170 people at June 30, 2013.

Other income for the fiscal years ended June 30, 2014 and 2013 was $148,753 and $83,758, respectively. The increase in other income is due an increase in interest income, scrap and miscellaneous income.

The effective income tax rate was 20.3% in fiscal 2014 and 29.3% in fiscal 2013. The effective tax rate is less than the statutory tax rate mainly due to the benefit the Company receives on its “qualified production activities” under The American Jobs Creation Act of 2004 and the benefit derived from the dividends paid on allocated ESOP shares.

Net income for fiscal 2014, was $1,167,885 or $.52 and $.51 per share, basic and diluted, respectively, compared to net income of $5,562,425 or $2.52 and $2.48 per share, basic and diluted, respectively, for fiscal 2013. The decrease in net income per share was primarily due to lower sales, lower gross profits, and higher selling, general, and administrative expenses.

Liquidity and Capital Resources

The Company's working capital is an appropriate indicator of the liquidity of its business, and during the past two fiscal years, the Company, when possible, has funded all of its operations with cash flows resulting from operating activities and when necessary from its existing cash and investments. The Company did not borrow any funds during the last two fiscal years. 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 June 30, 2014 and 2013 was $27,251,483 and $29,591,453, respectively. During the three months ended June 30, 2014 and 2013 the Company did not repurchase any shares of its common stock. During the fiscal year ended June 30, 2014 the Company did not repurchase any shares of its common stock. During the fiscal year ended June 30, 2013 the Company repurchased 5,753 shares of its common stock from the Company’s Employee Retirement Plan and Trust (“ESOP”) and in other open market transactions, for a total purchase price of $150,020. Under existing authorizations from the Company's Board of Directors, as of June 30, 2014, management is authorized to purchase an additional $1,706,248 million of Company stock.

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

	2014	2013
Net cash provided by operating activities	$5,387,543	$3,285,630
Net cash used in investing activities	(1,705,547)	(990,225)
Net cash used in financing activities	(4,013,733)	(3,930,201)

Net cash provided by operating activities fluctuates between periods primarily as a result of differences in net income, level of sales, the timing of the collection of accounts receivable, purchase of inventory and payments of accounts payable. Net cash used in investing activities increased in fiscal 2014 primarily due to investments in capital equipment and a net increase in purchase of investment securities offset by the maturity of investment securities. The increase in cash used in financing activities is due primarily to dividends paid on common stock offset by a decrease in proceeds received from exercised stock options.

The Company currently believes that the cash flow generated from operations and when necessary, from cash and cash equivalents will be sufficient to meet its long-term funding requirements for the foreseeable future.

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

During fiscal year 2014 and fiscal 2013, the Company expended $709,972 and $322,507, 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.

Critical Accounting Policies and Estimates

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

Revenue Recognition and Estimates

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

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

Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of Espey Mfg. & Electronics Corp.

We have audited the accompanying balance sheets of Espey Mfg. & Electronics Corp. as of June 30, 2014 and 2013, and the related statements of comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the two-year period ended June 30, 2014. Espey Mfg. & Electronics Corp.'s management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Espey Mfg. & Electronics Corp. as of June 30, 2014 and 2013, and the results of its operations and its cash flows for each of the years in the two-year period ended June 30, 2014 in conformity with accounting principles generally accepted in the United States of America.

/s/ EFP Rotenberg, LLP

EFP Rotenberg, LLP

Rochester, New York

September 17, 2014

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Espey Mfg. & Electronics Corp.

Balance Sheets

June 30, 2014 and 2013

	2014	2013
ASSETS		
Cash and cash equivalents	$9,556,891	9,888,628
Investment securities	4,910,893	3,892,968
Trade accounts receivable, net	3,194,678	7,204,226
Income tax receivable	943,234	—
Inventories:		
Raw materials	1,616,990	1,607,112
Work-in-process	792,618	607,165
Costs related to contracts in process, net of progress payments of $142,616 in 2014 and $146,916 in 2013	8,201,642	9,159,493
Total inventories	10,611,250	11,373,770
Deferred tax asset	324,823	419,093
Prepaid expenses and other current assets	177,776	315,736
Total current assets	29,719,545	33,094,421
Property, plant and equipment, net	2,678,901	2,421,332
Loan receivable	—	25,194
Total assets	$32,398,446	$35,540,947
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$727,281	$1,273,142
Accrued expenses:		
Salaries, wages and commissions	413,989	370,554
Vacation	693,286	748,040
Other	579,953	629,878
Payroll and other taxes withheld and accrued	53,553	50,891
Income taxes payable	—	430,463
Total current liabilities	2,468,062	3,502,968
Deferred tax liability	283,439	195,385
Total liabilities	2,751,501	3,698,353
Common stock, par value $.33-1/3 per share Authorized 10,000,000 shares; Issued 3,029,874 shares in 2014 and 2013. Outstanding 2,368,110 and 2,344,690 in 2014 and 2013, respectively (includes 97,500 and 116,666 Unearned ESOP Shares)	1,009,958	1,009,958
Capital in excess of par value	16,429,220	15,780,009

Accumulated other comprehensive (loss) income	(1,437)	412
Retained earnings	20,946,940	24,260,121
	38,384,681	41,050,500
Less: Unearned ESOP shares	(1,408,872)	(1,685,827)
Cost of 661,764 and 685,184 shares of common stock in treasury in 2014 and 2013, respectively	(7,328,864)	(7,522,079)
Total stockholders' equity	29,646,945	31,842,594
Total liabilities and stockholders' equity	$32,398,446	$35,540,947

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

Espey Mfg. & Electronics Corp.

Statements of Comprehensive Income

Years ended June 30, 2014 and 2013

	2014	2013
Net sales	$27,136,919	$34,298,210
Cost of sales	22,605,673	23,598,641
Gross profit	4,531,246	10,699,569
Selling, general and administrative expenses	3,214,050	2,917,140
Operating income	1,317,196	7,782,429
Other income		
Interest and dividend income	40,612	35,813
Other	108,141	47,945
Total other income	148,753	83,758
Income before income taxes	1,465,949	7,866,187
Provision for income taxes	298,064	2,303,762
Net income	$1,167,885	$5,562,425
Other comprehensive income, net of tax:		
Unrealized loss on investment securities	(1,849)	(1,065)
Total comprehensive income	$1,166,036	$5,561,360
Net income per share:		
Basic	$0.52	$2.52
Diluted	$0.51	$2.48
Weighted average number of shares outstanding:		
Basic	2,245,222	2,206,937
Diluted	2,285,535	2,242,648

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

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Espey Mfg. & Electronics Corp.

Statements of Changes in Stockholders' Equity

Years Ended June 30, 2014 and 2013

	Outstanding Shares	Common Amount	Capital in Excess of Par Value	Accumulated Other Comprehensive Income (Loss)	Retained Earnings
Balance as of June 30, 2012	2,320,822	$1,009,958	$15,093,512	$ 1,477	$23,053,762
Comprehensive income:					
Net income, 2013					5,562,425
Other comprehensive loss, net of tax of $(573)				(1,065)	
Total comprehensive income					
Stock options exercised	27,300		268,049		
Stock option expense			115,183		
Dividends paid on common stock $1.975 per share					(4,356,066)
Tax effect of stock options exercised			16,509		
Sale of treasury stock to ESOP	2,321		46,954		
Purchase of treasury stock	(5,753)				
Reduction of unearned ESOP shares			239,802		
Balance as of June 30, 2013	2,344,690	$1,009,958	$15,780,009	$ 412	$24,260,121
Comprehensive income:					
Net income, 2014					1,167,885
Other comprehensive loss, net of tax of $(995)				(1,849)	
Total comprehensive income					
Stock options exercised	23,420		247,876		
Stock option expense			99,050		
Dividends paid on common stock $2.000 per share					(4,481,066)
Tax effect of stock options exercised			26,242		
Sale of treasury stock to ESOP					
Purchase of treasury stock					
Reduction of unearned ESOP shares			276,043		
Balance as of June 30, 2014	2,368,110	$1,009,958	$16,429,220	$ (1,437)	$20,946,940

(Continued)

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

Espey Mfg. & Electronics Corp.

Statements of Changes in Stockholders' Equity

Years Ended June 30, 2014 and 2013

	Treasury Stock		Unearned ESOP	Total Stockholders
	Shares	Amount	Shares	Equity
Balance as of June 30, 2012	709,052	$(7,616,432)	$(1,974,829)	$29,567,448
Comprehensive income:				
Net income, 2013				5,562,425
Other comprehensive loss, net of tax of $(573)				(1,065)
Total comprehensive income				5,561,360
Stock options exercised	(27,300)	225,225		493,274
Stock option expense				115,183
Dividends paid on common stock $1.975 per share				(4,356,066)
Tax effect of stock options exercised				16,509
Sale of treasury stock to ESOP	(2,321)	19,148		66,102
Purchase of treasury stock	5,753	(150,020)		(150,020)
Reduction of unearned ESOP shares			289,002	528,804
Balance as of June 30, 2013	685,184	$(7,522,079)	$(1,685,827)	$31,842,594
Comprehensive income:				
Net income, 2014				1,167,885
Other comprehensive loss, net of tax of $(995)				(1,849)
Total comprehensive income				1,166,036
Stock options exercised	(23,420)	193,215		441,091
Stock option expense				99,050
Dividends paid on common stock $2.000 per share				(4,481,066)
Tax effect of stock options exercised				26,242
Sale of treasury stock to ESOP				—
Purchase of treasury stock				—
Reduction of unearned ESOP shares			276,955	552,998
Balance as of June 30, 2014	661,764	$(7,328,864)	$(1,408,872)	$29,646,945

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

Espey Mfg. & Electronics Corp.

Statements of Cash Flows

Years Ended June 30, 2014 and 2013

	2014	2013
Cash Flows from Operating Activities:		
Net income	$1,167,885	$5,562,425
Adjustments to reconcile net income to net cash provided by operating activities:		
Excess tax benefits from share-based compensation	(26,242)	(16,509)
Stock-based compensation	99,050	115,183
Depreciation	452,390	418,149
ESOP compensation expense	552,998	528,804
Loss on disposal of assets	13	6,222
Deferred income tax expense (benefit)	183,319	(22,641)
Changes in assets and liabilities:		
Decrease (increase) in trade receivables, net	4,009,548	(3,986,351)
Increase in income tax receivable	(943,234)	—
Decrease in inventories, net	762,520	271,936
Decrease (increase) in prepaid expenses and other current assets	137,960	(115,414)
Decrease in accounts payable	(545,861)	(35,895)
Increase (decrease) in accrued salaries, wages and commissions	43,435	(47,123)
(Decrease) increase in vacation accrual	(54,754)	40,280
(Decrease) increase in other accrued expenses	(49,925)	187,183
Increase in payroll and other taxes withheld and accrued	2,662	6,005
(Decrease) increase in income taxes payable	(404,221)	373,376
Net cash provided by operating activities	$5,387,543	$3,285,630

(Continued)

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

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Espey Mfg. & Electronics Corp.

Statements of Cash Flows

Years Ended June 30, 2014 and 2013

	2014	2013
Cash Flows from Investing Activities:		
Additions to property, plant and equipment	(709,972)	(322,507)
Proceeds from loan receivable	25,194	42,177
Purchase of investment securities	(3,456,934)	(7,359,816)
Proceeds from sale/maturity of investment securities	2,436,165	6,649,921
Net cash used in investing activities	(1,705,547)	(990,225)
Cash Flows from Financing Activities:		
Sale of treasury stock	—	66,102
Dividends on common stock	(4,481,066)	(4,356,066)
Purchase of treasury stock	—	(150,020)
Proceeds from exercise of stock options	441,091	493,274
Excess tax benefits from share-based compensation	26,242	16,509
Net cash used in financing activities	(4,013,733)	(3,930,201)
Decrease in cash and cash equivalents	(331,737)	(1,634,796)
Cash and cash equivalents, beginning of the year	9,888,628	11,523,424
Cash and cash equivalents, end of the year	$9,556,891	$9,888,628
Supplemental Schedule of Cash Flow Information:		
Income taxes paid	$1,462,200	$1,960,000

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

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Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 1. Nature of operations

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

Note 2. Summary of Significant Accounting Policies

Inventory Valuation, Cost Estimation and Revenue Recognition

Raw materials are valued at weighted average cost.

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

Revenue is recognized on contracts in the period in which the units are delivered and billed (units-of-delivery method). A significant portion of our business is comprised of development and production contracts. Generally, revenues on long-term fixed-price contracts are recorded on a percentage of completion basis using units of delivery as the measurement basis for progress toward completion.

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

Depreciation

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

Estimated useful lives of depreciable assets are as follows:

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

Income Taxes

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

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

Cash and Cash Equivalents

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

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 2. Summary of Significant Accounting Policies, *Continued*

Investment Securities

The Company accounts for its investments in accordance with ASC 320-10-25, “Accounting for Certain Investments in Debt and Equity Securities.” Investment securities at June 30, 2014 and June 30, 2013 consist of certificates of deposit and municipal bonds. The Company classifies investment securities as available-for-sale. Unrealized holding gains and losses, net of related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of stockholders’ equity until realized. Realized gains and losses for securities classified as available-for-sale are included in earnings and are determined using the specific identification method. Interest income is recognized when earned. Fair values are based on quoted market prices available as of the balance sheet date.

Accounts receivable and allowance for doubtful accounts

The Company extends credit to its customers in the normal course of business and collateral is generally not required for trade receivables. Exposure to credit risk is controlled through the use of credit approvals, credit limits and monitoring procedures. Accounts receivable are reported net of an allowance for doubtful accounts. The Company estimates the allowance based on its analysis of specific balances. An account is generally considered past due after thirty (30) days from the invoice date. Based on these factors, there was an allowance for doubtful accounts of $3,000 at June 30, 2014 and 2013. Changes to the allowance for doubtful accounts are charged to expense and reduced by charge-offs, net of recoveries.

Per Share Amounts

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

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income for fiscal years ended June 30, 2014 and 2013 consists of unrealized holding gains and losses on available-for-sale securities.

Use of Estimates

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

Investment Tax Credits

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

Reclassifications

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

Recently Issued Accounting Standards

In 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.

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 2. Summary of Significant Accounting Policies, *Continued*

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 2017.

Impairment of Long-Lived Assets

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

Concentrations of Risk

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

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

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

Note 3. 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 June 30, 2014 and June 30, 2013 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 June 30, 2014 and June 30, 2013 are as follows:

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Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 3. Investment in Fair Value, *Continued*

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2014				
Certificates of deposit	$4,063,000	$ —	$ —	$4,063,000
Municipal bonds	850,103	2,857	(5,067)	847,893
2014 Total investment securities	$4,913,103	$ 2,857	$ (5,067)	$4,910,893
2013				
Certificates of deposit	$2,600,000	$ —	$ —	$2,600,000
Municipal bonds	1,292,335	5,414	(4,780)	1,292,968
2013 Total investment securities	$3,892,335	$ 5,414	$ (4,780)	$3,892,968

The portfolio is diversified and highly liquid and primarily consists of investment grade fixed income instruments. At June 30, 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 June 30, 2014.

As of June 30, 2014 and June 30, 2013, the contractual maturities of available-for-sale securities were as follows:

	Years to Maturity		
	Less than One Year	One to Five Years	Total
2014			
Available-for-sale	$4,434,575	$476,318	$4,910,893
2013			
Available-for-sale	$2,077,769	$1,815,199	$3,892,968

Note 4. Contracts in Process

Contracts in process at June 30, 2014 and 2013 are as follows:

	2014	2013
Gross contract value	$35,663,830	$42,069,522
Costs related to contracts in process, net of progress payments of $142,616 in fiscal 2014 and $146,916 in fiscal 2013	8,201,642	9,159,493

Included in costs relating to contracts in process at June 30, 2014 and 2013 are costs of $4,391,834 and $4,155,629, respectively, relative to contracts that may not be completed within the ensuing year. Under the units-of-delivery method, the related sale and cost of sales will not be reflected in the statement of comprehensive income until the units under contract are shipped.

Note 5. Property, Plant and Equipment

A summary of the original cost of property, plant and equipment at June 30, 2014 and 2013 is as follows:

	2014	2013
Land	$45,000	$45,000
Building and improvements	4,256,890	4,254,834
Machinery and equipment	8,340,897	7,650,014
Furniture and fixtures	160,867	160,867
	12,803,654	12,110,715
Accumulated depreciation	(10,124,753)	(9,689,383)
Property, plant and equipment, net	$2,678,901	$2,421,332

Depreciation expense was $452,390 and $418,149, during the years ended June 30, 2014 and 2013, respectively.

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 6. Pension Expense

Under terms of a negotiated union contract which expires on June 30, 2015, the Company is obligated to make contributions to a union-sponsored International Brotherhood of Electrical Workers Local 1799 defined benefit pension plan (Plan identifying number is 14-6065199) covering eligible employees. Such contributions and expenses are based upon hours worked at a specified rate and amounted to $96,776 in fiscal 2014 and $98,712 in fiscal 2013. These contributions represent more than five percent of the total plan contributions. For the year beginning January 1, 2014, the Plan is in the “green zone” which means it is neither endangered nor critical status. For the year beginning January 1, 2013, the Plan was in “critical status.” Plan Trustees entered into a Funding Improvement Plan which calls for an increase in hourly contributions starting January 1, 2016 of $0.04 for each year for five years thereafter.

The Company sponsors a 401(k) plan for non-union workers with employee and employer matching contributions. The employer match is 10% of the employee contribution and was $47,847 and $40,521, for fiscal years 2014 and 2013, respectively.

Note 7. Provision for Income Taxes

A summary of the components of the provision for income taxes for the years ended June 30, 2014 and 2013 is as follows:

	2014	2013
Current tax expense - federal	$113,245	$2,293,795
Current tax expense - state	1,500	32,608
Deferred tax expense (benefit)	183,319	(22,641)
Provision for income taxes	$298,064	$2,303,762

Deferred income taxes reflect the impact of "temporary differences" between the amount of assets and liabilities for financial reporting purposes and such amounts measured by tax laws and regulations. These "temporary differences" are determined in accordance with ASC 740-10.

The combined U.S. federal and state effective income tax rates of 20.3% and 29.3%, for 2014 and 2013 respectively, differed from the statutory U.S. federal income tax rate for the following reasons:

	2014	2013
U.S. federal statutory income tax rate	34.0 %	34.0%
Increase (reduction) in rate resulting from:		
State franchise tax, net of federal income tax benefit	0.8	0.3
ESOP cost versus Fair Market Value	6.4	1.0
Dividend on allocated ESOP shares	(20.4)	(3.4)
Qualified production activities	(0.8)	(2.9)
Stock-based compensation	0.1	0.3
Other	0.2	—
Effective tax rate	20.3 %	29.3%

For the years ended June 30, 2014 and 2013 deferred income tax expense of $183,319 and benefit of $22,641, respectively, result from the changes in temporary differences for each year. The tax effects of temporary differences that give rise to deferred tax assets and deferred tax liabilities as of June 30, 2014 and 2013 are presented as follows:

	2014	2013
Deferred tax assets:		
Accrued expenses	$266,255	$348,085
ESOP	116,981	121,315
Stock-based compensation	23,854	19,946
Inventory - effect on uniform capitalization	32,749	49,032
Other	1,191	2,252
Total deferred tax assets	$441,030	$540,630
Deferred tax liabilities:		
Unrealized (loss) gain on investment securities	(773)	222
Property, plant and equipment - principally due to differences in depreciation methods	400,419	316,700
Total deferred tax liabilities	399,646	316,922
Net deferred tax asset	$41,384	$223,708

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 7. Provision for Income Taxes, *Continued*

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projection for future taxable income over the period in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these temporary differences without consideration of a valuation allowance.

As the result of the implementation of the FASB interpretation ASC 740-10, Accounting for Uncertainty in Income Taxes – An Interpretation of ASC 740, the Company recognized no material adjustments to unrecognized tax benefits. As of June 30, 2014 and 2013, the Company has no unrecognized tax benefits.

The Company recognizes interest and penalties related to uncertain tax positions, if any, in general and administrative expense. As of June 30, 2014, the Company has not recorded any provision for accrued interest and penalties related to uncertain tax positions.

By statute, tax years ended June 30, 2014, 2013, 2012, and 2011 remain open to examination by the major taxing jurisdictions to which the Company is subject.

Note 8. Significant Customers

A significant portion of the Company's business is the production of military and industrial electronic equipment for use by the U.S. and foreign governments and certain industrial customers. Sales to two domestic customers and one foreign customer (based in United Kingdom) accounted for 47% and 12%, respectively of total sales in fiscal 2014. Sales to two domestic customers and one foreign customer (based in United Kingdom) accounted for 45% and 18%, respectively of total sales in fiscal 2013.

Export sales in fiscal 2014 and fiscal 2013 were approximately $3,030,000 and $2,671,000, respectively.

Note 9. Stock Rights Plan

The Company has a Shareholder Rights Plan that expires on December 31, 2019. Under this plan, common stock purchase rights were distributed as a dividend at the rate of one right for each share of common stock outstanding as of or issued subsequent to April 14, 1989. Each right entitles the holder thereof to buy one-half share of common stock of the Company at an exercise price of $25 per share subject to adjustment. The rights are exercisable only if a person or group acquires beneficial ownership of 15% or more of the Company's common stock or commences a tender or exchange offer which, if consummated, would result in the offeror individually or, together with all affiliates and associates thereof, being the beneficial owner of 15% or more of the Company's common stock.

If a 15% or larger shareholder should engage in certain self-dealing transactions or a merger with the Company in which the Company is the surviving corporation and its shares of common stock are not changed or converted into equity securities of any other person, or if any person were to become the beneficial owner of 15% or more of the Company's common stock, then each right not owned by such shareholder or related parties of such shareholder (all of which will be void) will entitle its holder to purchase, at the right's then current exercise price, shares of the Company's common stock having a value of twice the right's exercise price. In addition, if the Company is involved in any other merger or consolidation with, or sells 50% or more of its assets or earning power to another person, each right will entitle its holder to purchase, at the right's then current exercise price, shares of common stock of such other person having a value of twice the right's exercise price.

The Company generally is entitled to redeem the rights at one cent per right at any time until the 15th day (or 25th day if extended by the Company's Board of Directors) following public announcement that a 15% position has been acquired or the commencement of a tender or exchange offer which, if consummated, would result in the offeror, together with all affiliates and associates thereof, being the beneficial owner of 15% or more of the Company's common stock.

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 10. 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 $552,998 and $528,804 for the years ended June 30, 2014 and 2013, respectively. The ESOP shares as of June 30, 2014 and 2013 were as follows:

	2014	2013
Allocated shares	472,192	469,338
Unreleased shares	97,500	116,666
Total shares held by the ESOP	569,692	586,004
Fair value of unreleased shares	$2,449,200	$2,998,316

Note 11. Stock-based Compensation

The Company follows ASC 718 in establishing standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, as well as transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity’s equity instruments or that may be settled by the issuance of those equity instruments. ASC 718 requires that the cost resulting from all share-based payment transactions be recognized in the financial statements based on the fair value of the share-based payment. ASC 718 establishes fair value as the measurement objective in accounting for share-based payment transactions with employees, except for equity instruments held by employee share ownership plans.

Total stock-based compensation expense recognized in the statement of comprehensive income for the three-month period ended June 30, 2014 and 2013, was $21,329 and $27,406, respectively, before income taxes. The related total deferred tax benefit was approximately $2,308 and $3,116, for the same periods. Total stock-based compensation expense recognized in the statement of comprehensive income for the fiscal years ended June 30, 2014 and 2013, was $99,050 and $115,183, respectively, before income taxes. The related total deferred tax benefit was approximately $10,862 and $12,968, for the same periods. ASC 718 requires the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options to be classified and reported as both an operating cash outflow and a financing cash inflow.

As of June 30, 2014, there was approximately $60,800 of unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over the next 1.25 years. The total deferred tax benefit related to these awards is approximately $6,395.

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 are authorized for issuance under the 2007 Plan, of which 190,100 have been granted and 133,425 are outstanding as of June 30, 2014. While no further grants of options may be made under the 2000 Plan, as of June 30, 2014, 28,130 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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Note 11. Stock-based Compensation, *Continued*

The table below outlines the weighted average assumptions that the Company used to calculate the fair value of each option award for the year ended June 30, 2014. There were no options awarded for the twelve months ended June 30, 2013.

	2014
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 has paid a special cash dividend of $1.00 per share in each of fiscal years 2014 and 2013. 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 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 twelve months ended June 30, 2014:

	Employee Stock Options Plan			
	Number of Shares Subject to Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Balance at July 1, 2013	159,250	$ 21.12	6.30	
Granted	31,600	$ 27.22	9.15	
Exercised	(23,420)	$ 18.83	—	
Forfeited or expired	(5,875)	$ 27.13	—	
Outstanding at June 30, 2014	161,555	$ 22.43	6.02	$491,514
Vested or expected to vest at June 30, 2014	158,440	$ 22.33	5.95	$491,514
Exercisable at June 30, 2014	135,580	$ 21.51	5.42	$491,514

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 June 30, 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 June 30, 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 twelve months ended June

30, 2014 and 2013 was $155,671 and $82,656, respectively.

The following table summarizes changes in non-vested stock options during the twelve months ended June 30, 2014:

	Number of Shares Subject to Option	Weighted Average Grant Date Fair Value (per Option)
Non-Vested at July 1, 2013	57,950	$ 4.321
Granted	31,600	3.777
Vested	(57,700)	4.323
Forfeited or expired	(5,875)	3.782
Non-Vested at June 30, 2014	25,975	$ 3.777

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Note 12. Financial Instruments/Concentration of Credit Risk

The carrying amounts of financial instruments, including cash and cash equivalents, short term investments, accounts receivable, accounts payable and accrued expenses, approximated fair value as of June 30, 2014 and 2013 because of the relatively short maturities of these instruments.

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, short-term investments and accounts receivable. The Company maintains cash and cash equivalents with various financial institutions. At times such investments may be in excess of FDIC insurance limits. As disclosed in note 8, a significant portion of the Company's business is the production of military and industrial electronic equipment for use by the U.S. and foreign governments and certain industrial customers. The related accounts receivable balance, as a percentage of the Company's total trade accounts receivable balance, was 61% represented by three customers at June 30, 2014, and 52% by two customers at June 30, 2013.

Although the Company's exposure to credit risk associated with nonpayment of these concentrated balances is affected by the conditions or occurrences within the U.S. and foreign governments, the Company believes that its trade accounts receivable credit risk exposure is limited. The Company performs ongoing credit evaluations of its customer's financial conditions and requires collateral, such as progress payments, in certain circumstances. The Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other information.

Note 13. Related Parties

The administration of the shares of common stock held by the ESOP Trust is subject to the Second Amended and Restated Plan, effective as of July 1, 2002, creating the Trust, and a Trust Agreement dated July 15, 2005. The Trustees' rights with respect to the disposition of shares are governed by the terms of the Plan and the Trust Agreement. As to shares that have been allocated to the accounts of participants in the ESOP Trust, the Plan provides that the Trustees are required to vote such shares in accordance with instructions received from the participants. As to unallocated shares and allocated shares for which voting instructions have not been received from participants, the Plan provides that the Trustees are required to vote such shares in accordance with the direction of a Committee, appointed by the Board of Directors of the Company under the terms of the Plan and Trust Agreement. See note 10 for additional information regarding the ESOP.

Note 14. 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 June 30, 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 government may, in certain cases, also terminate existing contracts, recover damages, and impose other sanctions and penalties. As a result of contract audits the Company will determine a range of possible outcomes and in accordance with ASC 450 “Contingencies” the Company will accrue amounts within a range that appears to be its best estimate of a possible outcome. Adjustments are made to accruals, if any, periodically based on current information.

Note 15. Stockholders' Equity

Reservation of Shares

The Company has reserved common shares for future issuance as follows as of June 30, 2014:

Stock options outstanding	161,555
Stock options available for issuance	226,925
Number of common shares reserved	388,480

The following table sets forth the reconciliation of the numerators and denominators of the basic and diluted per share computations for continuing operations for the years ended June 30:

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Note 15. Stockholders' Equity, *Continued*

	2014	2013
Numerator:		
Net Income	$1,167,885	$5,562,425
Denominator:		
Basic EPS:		
Common shares outstanding, beginning of period	2,344,690	2,320,822
Unearned ESOP shares	(116,666)	(136,666)
Weighted average common shares issued during the period	9,991	17,810
Weighted average common shares purchased during the period	—	(2,550)
Weighted average ESOP shares earned during the period	7,207	7,521
Denominator for basic earnings per common shares –		
Weighted average common shares	2,245,222	2,206,937
Diluted EPS:		
Common shares outstanding, beginning of period	2,344,690	2,320,822
Unearned ESOP shares	(116,666)	(136,666)
Weighted average common shares issued during the period	9,991	17,810
Weighted average common shares purchased during the period	—	(2,550)
Weighted average ESOP shares earned during the period	7,207	7,521
Weighted average dilutive effect of issued or forfeited shares	40,313	35,711
Denominator for diluted earnings per common shares –		
Weighted average common shares	2,285,535	2,242,648

Not included in this computation of earnings per share for the year ended June 30, 2014 were options to purchase 25,975 shares of the Company’s common stock. These options were excluded because their inclusion would have been anti-dilutive due to the average strike price exceeding the average market price of those shares. There were no anti-dilutive options for the year ended June 30, 2013.

Note 16. Line of Credit

At June 30, 2014, the Company has an uncommitted and unused Line of Credit with a financial institution. The agreement provides that the Company may borrow up to $3,000,000. The line provides for interest payments equal to the LIBOR Daily Floating Rate plus 2.00%. Any borrowing under the line of credit will be collateralized by accounts receivable. The line will be reviewed annually for renewal. All outstanding balances are payable no later than the expiration date of the agreement, unless other terms are agreed to by the lender.

Note 17. Quarterly Financial Information (Unaudited)

2014	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales				