

ESPEY MFG & ELECTRONICS CORP
Form 10-K
September 12, 2018

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, 2018

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 American

Common Stock Purchase Rights NYSE American

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 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 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.

Yes No

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

Yes No

Indicate by check mark 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 Smaller reporting company

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was \$40,076,299 based upon the closing sale price of \$23.96 on the NYSE American on December 31, 2017.

At September 4, 2018 there were 2,388,224 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 2018 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" and 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;

- General strength of the industry sectors in which our customers transact business

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. 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 American 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 9001:2015 and AS9100:2016 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.

Espey’s 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 and testing process are subcontracted to vendors from time to time.

In fiscal years ended June 30, 2018 and 2017, the Company's total sales were \$32,517,883 and \$22,521,012, respectively. Sales to two domestic customers accounted for 33% and 27% of total sales in 2018. Sales to two domestic customers accounted for 29% and 16% of total sales in 2017. This high concentration level with these customers presents significant risk. A loss of one of these customers or programs related to these customers could significantly impact the financial performance of 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.

Export sales in fiscal years 2018 and 2017 were approximately \$3,112,000 and \$1,730,000, respectively. This increase is primarily due to the increase in power supply and antenna shipments to specific customers.

Sources of Raw Materials

The Company has not typically experienced any significant delays or shortages 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 its products are available from a single or a limited number of sources. Despite the risk associated with single or limited 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. At times replacements are required to cover obsolete parts.

The power electronics industry is experiencing sustained growth and continuing demand from multiple manufacturing sectors. This growth has created volatility and unpredictability in the availability of certain electronic components and, in some cases, has created industry shortages. These shortages have a strong potential to impact our ability to support our customer's schedule demands, as lead times for these components have, in some instances, increased from readily available to waiting times of nearly a year or more. We are working with our customers to mitigate adverse impact upon our ability to service their requirements resulting from the current industry-wide phenomenon.

In 2018, the President of the United States directed the imposition of tariffs on steel and aluminum imports from various countries. While currently we are not experiencing any significant financial or raw material sourcing issues resulting from the product tariffs, the Company cannot provide any assurance that the existing tariffs, the potential of additional tariffs, and the associated volatility arising from the Administration's foreign trade policies, will not have a negative impact on our future earnings by increasing our raw material prices and augmenting the lead time for the availability of raw materials. From time to time the Company must identify parts to replace parts which are no longer produced.

Sales Backlog

The total backlog at June 30, 2018 was approximately \$48.1 million compared to approximately \$43.1 million at June 30, 2017. 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, 2018 is approximately \$45.0 million. This includes items that have been authorized and appropriated by Congress and/or funded by the customer. The unfunded backlog at June 30, 2018 is approximately \$3.1 million and represents a firm multi-year order 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 individual programs, 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, 2017 was \$7.5 million. For both fiscal years ended 2018 and 2017, the unfunded backlog is comprised primarily of the same multi-year order from a single customer. The Company's backlog and risks associated with government contracts is discussed in greater detail below.

It is presently anticipated that a minimum of \$40.6 million of orders comprising the June 30, 2018 backlog will be filled during the fiscal year ending June 30, 2019. The minimum of \$40.6 million does not include any shipments which may be made against orders received subsequently to the fiscal year ending June 30, 2018. The estimate of the June 30, 2018 backlog to be shipped in fiscal year 2019 is subject to future events, which may cause the amount of the backlog actually shipped to differ from such estimate.

Marketing and Competition

The Company markets its products primarily through its own direct sales organization and through outside sales representatives. Business is solicited from large industrial manufacturers and defense companies, the government of the United States, foreign governments and major foreign electronic equipment companies. Espey is also on the eligible list of contractors with the United States Department of Defense. We pursue opportunities for prime contracts directly with the Department of Defense and are generally automatically solicited by Department of Defense procurement agencies for their needs falling within the major classes of products produced by the Company. Espey contracts with the Federal Government under cage code 20950 as Espey Mfg. & Electronics Corp.

There is competition in all classes of products manufactured by the Company ranging from divisions of the largest electronic companies, to many small companies. The Company's sales do not represent a significant share of the industry's market for any class of its products. The principal methods of competition for electronic products of both a military and industrial nature include, among other factors, price, product performance, the experience of the particular company and history of its dealings in such products.

Our business is not seasonal. However, the concentration of our business in the rail industry, and in equipment for military applications and industrial applications and our customer concentrations expose us to on-going associated risks. These risks include, without limitation, requirements for power supplies in the rail industry, dependence on appropriations from the United States Government and the governments of foreign nations, program allocations, the potential of governmental termination of orders for convenience, and the general strength of the industry sectors in which our customers transact business.

Future procurement needs supporting the military and the rail industry continues to drive competition. For several years, many of our competitors have, and they continue to invest aggressively in upfront product design costs and accept lower profit margins as a strategic means of maintaining existing business and enhancing market share. This has put pressure on the pricing of our current products and has lowered our profit margins on some of our new

business. In order to compete effectively for new business, in some cases we have invested in upfront design costs, thereby reducing initial profitability as a means of procuring new long-term programs. As part of our strategy, we adjust our pricing in order to achieve a balance which enables us both to retain repeat programs while being more competitive in bidding on new programs. This trend will continue into fiscal year 2019.

In order to maintain a balanced business, we are continuing to place an emphasis on securing “build to print” opportunities, which will allow production work to go directly to the manufacturing floor, limiting the impact on our engineering staff. This effort will keep our manufacturing team busy while the products being developed transition to production.

Research and Development

Some of the Company's engineers and technicians spend varying amounts of time on either the development of new products or improvements to existing products. A majority of the resulting costs we incur relate to research that is required to support a request for quotation from a customer product-specific need usually associated with stringent size and weight requirements. We do very little pure research as our business primarily is driven by customer product needs and custom product development with some customer funding. The Company's expenditures for research and development were approximately \$18,206 and \$34,065 in fiscal year 2018 and 2017, respectively.

Employees

The Company had 164 employees as of August 31, 2018. During the year ended June 30, 2018, we increased the number of employees to support our business growth. Approximately 38% of these employees are represented by the International Brotherhood of Electrical Workers Local #1799. A new collective bargaining agreement was approved in July 2018. The four-year agreement expires on June 30, 2022. 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 2018, and the Company believes will not in fiscal year 2019, 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 dollars. Consequently, a strengthening of the United States dollar against foreign currencies 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.

Cyber or Other Security Threats or Other Disruptions

We routinely experience cybersecurity threats in the form of unauthorized attempts to gain access to our sensitive information. The threats we face vary from attacks common to most industries to more advanced attacks with the specific objective of accessing national security information. We believe our threat detection and mitigation processes and procedures are above adequate. The processes and procedures in place are designed to detect, manage and prevent current threats and respond quickly to detect and mitigate new threats. To ensure our systems remain protected, we continually assess and acquire, as appropriate, new available technology and provide employee training to utilize effectively our technological assets. Prior cyberattacks directed at us have not had a material impact on our financial results nor restricted us from being awarded contracts from other defense companies or directly from the United States Department of Defense. However, we can provide no assurance that the occurrence of any future event would not adversely affect our internal operations, our reputation and competitive advantage, and our future financial results.

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 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

We are party to various litigation matters and claims arising from time to time in the ordinary course of business. While the results of such matters cannot be predicted with certainty, we believe that the final outcome of such matters will not have a material adverse effect on our business, financial condition, results of operations or cash flows.

Item 4. Mine Safety Disclosures

Not applicable

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 American (symbol "ESP"), the principal market for trading in the common stock, for each quarterly period for the last two fiscal years ended June 30:

| <u>2018</u> | High | Low |
|----------------|---------|---------|
| First Quarter | \$24.40 | \$21.39 |
| Second Quarter | 24.07 | 21.07 |
| Third Quarter | 27.10 | 21.70 |
| Fourth Quarter | 29.97 | 25.50 |

| | | |
|----------------|---------|---------|
| 2017 | | |
| First Quarter | \$27.65 | \$25.10 |
| Second Quarter | 27.50 | 24.26 |
| Third Quarter | 26.50 | 22.31 |
| Fourth Quarter | 24.21 | 22.05 |

Holders

The approximate number of holders of record of the common stock was 75 on September 4, 2018 according to records of the Company's transfer agent. Included in this number are shares held in "nominee" or "street" name and, therefore, the number of beneficial owners of the common stock is believed to be substantially in excess of the foregoing number.

Dividends

The Company paid cash dividends on common stock of \$1.00 per share for each of the fiscal years ended June 30, 2018 and 2017. The Board of Directors has authorized the payment of a fiscal year 2019 first quarter regular dividend of \$0.25, and a special dividend of \$1.00, payable October 1, 2018 to shareholders of record on September 24, 2018. Our Board of Directors assesses the Company's dividend policy periodically. While there is no assurance that the Board of Directors will maintain the amount of the regular cash dividend or declare a special dividend during any future years, we believe that the Company is in the position to continue to pay the regular cash dividends for the foreseeable future.

During fiscal year 2018, 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, 20,601 shares were sold at prices that ranged from \$17.09 a share to \$25.18 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 year 2018 fourth quarter.

The following table sets forth information as of June 30, 2018 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 | 222,854 | \$ 24.29 | 349,095 |
| Equity compensation plans not approved by security holders | — | | — |
| Total | 222,854 | | 349,095 |

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

Management expects revenues in fiscal year 2019 to be higher than revenues during fiscal year 2018 but expects the gross profit margin to be lower in fiscal year 2019 than the gross profit margin during fiscal year 2018. This expectation is driven primarily by orders already in our backlog that will be shipped in fiscal year 2019. As market factors including competition and product costs impact gross profit margins, management will continue to evaluate our sales strategy, employment levels, and facility costs.

During fiscal year 2018 the Company received approximately \$37.5 million in new orders. Our total backlog at June 30, 2018 was approximately \$48.1 million, as compared to \$43.1 million at June 30, 2017. Currently, we expect a minimum of \$40.6 million of orders comprising the June 30, 2018 backlog will be filled during the fiscal year ending June 30, 2019. This \$40.6 million will be supplemented by shipments which may be made against orders received during the fiscal year.

Successful conversion of engineering program backlog into sales is largely dependent on the execution and completion of our engineering design efforts. It is not uncommon to experience technical or scheduling delays which arise from time to time as a result of, among other reasons, design complexity, the availability of personnel with the requisite expertise, and the requirements to obtain customer approval at various milestones. Cost overruns which may arise from technical and schedule delays could negatively impact the timing of the conversion of backlog into sales, or the profitability of such sales. While recently, we have been experiencing some technical and schedule delays with our major development programs, these delays have been resolved as they arise and we do not currently expect any negative impact on our customer order fulfillment projections for fiscal year 2019. Engineering programs in both the funded and unfunded portions of the current backlog aggregate \$8.8 million.

In addition to the backlog, the Company currently has outstanding opportunities representing in excess of \$69.6 million in the aggregate as of August 31, 2018, 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. Two significant customers represented 60% of the Company's total sales in fiscal year 2018 and two significant customers represented 45% of the Company's total sales in fiscal year 2017. These sales are in connection with multiyear programs in which the Company is a significant contractor. The June 30, 2018 backlog of \$48.1 million included orders from three customers that represent 23%, 16%, and 10%, respectively, of the total backlog. The June 30, 2017 backlog of \$43.1 million includes orders from three customers that represent 23%, 20% and 18%, respectively, of the total backlog. Although improvement has been made in customer concentrations, this high customer concentration level continues to present significant risk. A loss of one of these customers or programs related to these customers, or customer requested deferrals of product delivery 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. We continue to evaluate the

Company's business development functions and the implementation of potential alternative courses of action in order to diversify the Company's customer base. The quotations for non-repeat programs referred to above include several new customers.

Management, along with the Board of Directors, continues to evaluate the need and use of the Company's working capital. Capital expenditures, primarily for machinery and equipment, are expected to be approximately \$500,000 for fiscal year 2019. A majority of these expenditures will be made to stay competitive in the marketplace and to meet the needs of current contracts. 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, 2018 and 2017, were \$32,517,883 and \$22,521,012, respectively, a 44% increase. The increase in net sales in the current fiscal year is primarily due to an increase in power supply sales resulting from the commencement of shipments on a significant military contract and the increase in shipments to several existing customers offset, in part, by a decrease in magnetic shipments due to timing and completion of specific contracts.

For the fiscal years ended June 30, 2018 and 2017 gross profits were \$7,662,252 and \$4,714,568, respectively. Gross profit as a percentage of sales increased to 23.6% for fiscal year 2018, up from 20.9% in fiscal year 2017. The primary factors in determining the change in gross profit and net income are overall sales levels and product mix. The gross profits on mature products and build to print contracts are typically higher as compared to products which are still in the engineering development stage or in early stages of production. In the case of the latter, the Company can incur what it refers to as “loss contracts,” meaning engineering design contracts in which the Company invests with the objective of developing future product sales. In any given accounting period the mix of product shipments between higher margin programs and less mature programs, and expenditures associated with loss contracts, has a significant impact on gross profit and net income. The gross profit percentage increased in the twelve months ended June 30, 2018 as compared to the same period in 2017 primarily due to an increase in sales while expenditures incurred related to engineering design investments remained comparable to those incurred in the same period in 2017.

Selling, general and administrative expenses were \$3,808,395 for the fiscal year ended June 30, 2018, an increase of \$620,283, or 19.5% as compared to the prior year. The increase for fiscal year 2018 relates primarily to the increase in employee compensation costs, professional services, outside selling expenses incurred for outside sales representatives, and freight due to an increase in shipments.

Employment of full time equivalents at June 30, 2018 was 153 people compared with 136 people at June 30, 2017. The increase in headcount is primarily due to an increase in engineering and program management personnel in support of the Company’s sales backlog.

Other income for the fiscal years ended June 30, 2018 and 2017 was \$215,219 and \$124,949, respectively. The increase is primarily due to an increase in interest income resulting from the increase in investment securities and investment returns. Interest income is a function of the level of investments and investment strategies which generally tend to be conservative.

The Company’s effective income tax rate was 24.4% in fiscal year 2018 and 31.2% in fiscal year 2017. The effective tax rate is less than the statutory tax rate mainly due to the benefit the Company receives on its “qualified production activities” under The American Jobs Creation Act of 2004 and the benefit derived from the ESOP dividends paid on allocated shares. The Company’s effective tax rate for the fiscal year ended June 30, 2018 uses a blended statutory tax rate which factors the reduction in the corporate statutory tax rate authorized under the Tax Cuts and Jobs Act (the “Tax Act”) effective on January 1, 2018. The Company re-measured certain U.S. deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%, and provisionally recorded a net income tax expense of \$35,200 related to the re-measurement in the second quarter of fiscal year 2018.

Net income for fiscal year 2018 was \$3,075,797 or \$1.32 and \$1.31 per share, basic and diluted, respectively compared to net income of \$1,135,736 or \$0.49 per share, basic and diluted, for fiscal year 2017. The increase in net income per share for the twelve months ended June 30, 2018 was mainly due to high gross profit resulting from higher sales and higher gross profit percentage resulting from product mix with expenditures related to engineering design

investments made by the Company remaining comparable between periods. In addition, the Company received a benefit in the current period from the reduction in the Company's effective tax rate discussed above. The increase was offset, in part, by an increase in selling, general and administrative expenses primarily related to employee compensation costs resulting from an increase in headcount.

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 line is reviewed annually in November for renewal on December 1st.

The Company's working capital as of June 30, 2018 and 2017 was \$29,740,468 and \$29,853,018, respectively. During the twelve months ended June 30, 2018 the Company repurchased 4,798 shares of its common stock, respectively, from the Company's Employee Retirement Plan and Trust ("ESOP") for a purchase price of \$109,694, respectively. During the twelve months ended June 30, 2017 the Company repurchased 1,633 shares of its common stock, respectively, from the Company's ESOP for a purchase price of \$44,335, respectively. None of such purchases were made during the last three months of each fiscal year. Under existing authorizations from the Company's Board of Directors, as of June 30, 2018, management is authorized to purchase an additional \$876,297 of Company stock.

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

| | 2018 | 2017 |
|---|-------------|-------------|
| Net cash provided by operating activities | \$260,907 | \$6,420,723 |
| Net cash used in investing activities | (4,020,102) | (4,202,411) |
| Net cash used in financing activities | (2,000,172) | (2,191,793) |

Net cash provided by operating activities fluctuates between periods primarily as a result of differences in sales and net income, provision for income taxes, the timing of the collection of accounts receivable, purchase of inventory, and payment of accounts payable. The decrease in net cash provided by operating activities compared to the prior year primarily relates to an increase in accounts receivable, inventories and prepaid expenses and other current assets as well as a reduction in accounts payable. This was offset by an increase in net income resulting from higher sales in the current period. Net cash used in investing activities decreased in the twelve months of fiscal year 2018 as compared to the same period in fiscal year 2017 primarily due to an increase in maturing investments offset by an increase in the purchase of investments and property, plant and equipment. Cash used in financing activities consists primarily of dividend payments on common stock and the Company's purchase and issuance of treasury stock. The decrease in cash used in financing activities is due to an increase in proceeds received from the exercise of stock options offset, in part, from the increase in cash expended on shares purchased from the Company's ESOP and the increase in dividends paid fiscal year 2018 as compared to fiscal year 2017.

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

During fiscal years 2018 and 2017, the Company expended \$1,923,220 and \$352,132, respectively, for plant improvements and new equipment. The Company has budgeted approximately \$500,000 for new equipment and plant improvements in fiscal year 2019. Management anticipates that the funds required will be available from current operations.

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.

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.

Opinion on the Financial Statements

We have audited the accompanying balance sheets of Espey Mfg. & Electronics Corp (the Company) as of June 30, 2018 and 2017, the related statements of comprehensive income, changes in stockholders' equity and cash flows for each of the years ended June 30, 2018 and 2017, and the related notes to the financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of June 30, 2018 and 2017, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting 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.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Freed Maxick CPAs, P.C.

We have served as the Company's auditor since 2014.

Rochester, New York

September 12, 2018

Espey Mfg. & Electronics Corp.

Balance Sheets

June 30, 2018 and 2017

| | 2018 | 2017 |
|--|--------------|--------------|
| ASSETS | | |
| Cash and cash equivalents | \$4,298,796 | \$10,058,163 |
| Investment securities | 11,520,706 | 9,426,968 |
| Trade accounts receivable, net of allowance of \$3,000 | 4,377,726 | 3,399,613 |
| Income tax receivable | 161,975 | 120,179 |
| Inventories: | | |
| Raw materials | 1,562,581 | 1,303,259 |
| Work-in-process | 966,342 | 512,014 |
| Costs related to contracts in process, net of advance payments of \$102,924 and \$1,366,504 as of June 30, 2018 and 2017, respectively | 8,777,079 | 7,863,538 |
| Total inventories | 11,306,002 | 9,678,811 |
| Deferred tax assets | — | 317,559 |
| Prepaid expenses and other current assets | 1,292,575 | 227,306 |
| Total current assets | 32,957,780 | 33,228,599 |
| Property, plant and equipment, net | 3,758,637 | 2,265,096 |
| Total assets | \$36,716,417 | \$35,493,695 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Accounts payable | \$1,822,597 | \$2,250,115 |
| Accrued expenses: | | |
| Salaries and wages | 529,005 | 172,045 |
| Vacation | 707,612 | 656,199 |
| Other | 104,663 | 250,283 |
| Payroll and other taxes withheld | 53,435 | 46,939 |
| Total current liabilities | 3,217,312 | 3,375,581 |
| Deferred tax liabilities | 17,693 | 220,571 |
| Total liabilities | 3,235,005 | 3,596,152 |

Commitments and Contingencies (See Note 14)

Common stock, par value \$.33-1/3 per share

Authorized 10,000,000 shares; Issued 3,029,874 shares as of June 30, 2018 and 2017. Outstanding 2,387,124 and 2,371,321 as of June 30, 2018 and 2017, respectively

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| | | |
|--|------------------|------------------|
| (includes 29,166 and 45,000 Unearned ESOP Shares, respectively) | 1,009,958 | 1,009,958 |
| Capital in excess of par value | 18,201,691 | 17,650,335 |
| Accumulated other comprehensive loss | (6,349) | (3,599) |
| Retained earnings | 22,416,400 | 21,670,196 |
| | 41,621,700 | 40,326,890 |
| Less: Unearned ESOP shares | (421,453) | (650,248) |
| Cost of 642,750 and 658,553 shares of common stock in treasury as of June 30, 2018 and 2017, respectively | (7,718,835) | (7,779,099) |
| Total stockholders' equity | 33,481,412 | 31,897,543 |
| Total liabilities and stockholders' equity | \$36,716,417 | \$35,493,695 |

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

Espey Mfg. & Electronics Corp.

Statements of Comprehensive Income

Years Ended June 30, 2018 and 2017

| | 2018 | 2017 |
|--|--------------|--------------|
| Net sales | \$32,517,883 | \$22,521,012 |
| Cost of sales | 24,855,631 | 17,806,444 |
| Gross profit | 7,662,252 | 4,714,568 |
| Selling, general and administrative expenses | 3,808,395 | 3,188,112 |
| Operating income | 3,853,857 | 1,526,456 |
| Other income | | |
| Interest income | 160,650 | 88,836 |
| Other | 54,569 | 36,113 |
| Total other income | 215,219 | 124,949 |
| Income before provision for income taxes | 4,069,076 | 1,651,405 |
| Provision for income taxes | 993,279 | 515,669 |
| Net income | \$3,075,797 | \$1,135,736 |
| Other comprehensive income, net of tax: | | |
| Unrealized loss on investment securities | (2,750) | (2,191) |
| Total comprehensive income | \$3,073,047 | \$1,133,545 |
| Net income per share: | | |
| Basic | \$1.32 | \$0.49 |
| Diluted | \$1.31 | \$0.49 |
| Weighted average number of shares outstanding: | | |
| Basic | 2,333,885 | 2,312,870 |
| Diluted | 2,348,307 | 2,324,838 |

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, 2018 and 2017

| | Outstanding Shares | Common Amount | Capital in Excess of Par Value | Accumulated Other Comprehensive Income (Loss) | Retained Earnings |
|---|-----------------------|------------------|--------------------------------------|--|----------------------|
| Balance as of June 30, 2016 | 2,364,684 | \$ 1,009,958 | \$ 17,253,072 | \$ (1,408) | \$ 22,820,938 |
| Comprehensive income: | | | | | |
| Net income | | | | | 1,135,736 |
| Other comprehensive loss, net of tax of \$(1,179) | | | | (2,191) | |
| Total comprehensive income | | | | | |
| Stock options exercised | 8,300 | | 82,442 | | |
| Stock-based compensation | | | 129,167 | | |
| Dividends paid on common stock \$1.00 per share | | | | | (2,307,445) |
| Tax effect of stock options exercised | | | 9,070 | | |
| Tax effect of dividends on unallocated ESOP shares | | | | | 20,967 |
| Purchase of treasury stock | (1,663) | | | | |
| Reduction of unearned ESOP shares | | | 176,584 | | |
| Balance as of June 30, 2017 | 2,371,321 | \$ 1,009,958 | \$ 17,650,335 | \$ (3,599) | \$ 21,670,196 |
| Comprehensive income: | | | | | |
| Net income | | | | | 3,075,797 |
| Other comprehensive loss, net of tax of \$(394) | | | | (2,750) | |
| Total comprehensive income | | | | | |
| Stock options exercised | 20,601 | | 269,157 | | |
| Stock-based compensation | | | 123,112 | | |
| Dividends paid on common stock \$1.00 per share | | | | | (2,329,593) |
| Purchase of treasury stock | (4,798) | | | | |
| Reduction of unearned ESOP shares | | | 159,087 | | |
| Balance as of June 30, 2018 | 2,387,124 | \$ 1,009,958 | \$ 18,201,691 | \$ (6,349) | \$ 22,416,400 |

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, 2018 and 2017

| | Treasury Stock | | Unearned ESOP | Total Stockholders' Equity |
|---|----------------|---------------|------------------|----------------------------------|
| | Shares | Amount | Shares | |
| Balance as of June 30, 2016 | 665,190 | \$(7,803,239) | \$(891,083) | \$32,388,238 |
| Comprehensive income: | | | | |
| Net income | | | | 1,135,736 |
| Other comprehensive loss, net of tax of \$(1,179) | | | | (2,191) |
| Total comprehensive income | | | | 1,133,545 |
| Stock options exercised | (8,300) | 68,475 | | 150,917 |
| Stock-based compensation | | | | 129,167 |
| Dividends paid on common stock \$1.00 per share | | | | (2,307,445) |
| Tax effect of stock options exercised | | | | 9,070 |
| Tax effect of dividends on unallocated ESOP shares | | | | 20,967 |
| Purchase of treasury stock | 1,663 | (44,335) | | (44,335) |
| Reduction of unearned ESOP shares | | | 240,835 | 417,419 |
| Balance as of June 30, 2017 | 658,553 | \$(7,779,099) | \$(650,248) | \$31,897,543 |
| Comprehensive income: | | | | |
| Net income | | | | 3,075,797 |
| Other comprehensive loss, net of tax of \$(394) | | | | (2,750) |
| Total comprehensive income | | | | 3,073,047 |
| Stock options exercised | (20,601) | 169,958 | | 439,115 |
| Stock-based compensation | | | | 123,112 |
| Dividends paid on common stock \$1.00 per share | | | | (2,329,593) |
| Purchase of treasury stock | 4,798 | (109,694) | | (109,694) |
| Reduction of unearned ESOP shares | | | 228,795 | 387,882 |
| Balance as of June 30, 2018 | 642,750 | \$(7,718,835) | \$(421,453) | \$33,481,412 |

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

Espey Mfg. & Electronics Corp.

Statements of Cash Flows

Years Ended June 30, 2018 and 2017

| | 2018 | 2017 |
|---|--------------|--------------|
| Cash Flows from Operating Activities: | | |
| Net income | \$3,075,797 | \$1,135,736 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Excess tax benefits from share-based compensation | — | (9,070) |
| Tax effect of dividends on unallocated ESOP shares | — | 20,967 |
| Stock-based compensation | 123,112 | 129,167 |
| Depreciation | 429,679 | 435,557 |
| ESOP compensation expense | 387,882 | 417,419 |
| Loss on disposal of assets | — | 4 |
| Deferred income tax expense (benefit) | 115,075 | (46,488) |
| Changes in assets and liabilities: | | |
| (Increase) decrease in trade receivables, net | (978,113) | 1,557,851 |
| (Increase) decrease in income tax receivable | (41,796) | 218,189 |
| (Increase) decrease in inventories, net | (1,627,191) | 1,054,870 |
| Increase in prepaid expenses and other current assets | (1,065,269) | (7,618) |
| (Decrease) increase in accounts payable | (427,518) | 1,697,328 |
| Increase (decrease) in accrued salaries and wages | 356,960 | (185,865) |
| Increase (decrease) in vacation accrual | 51,413 | (48,562) |
| (Decrease) increase in other accrued expenses | (145,620) | 53,652 |
| Increase (decrease) in payroll and other taxes withheld | 6,496 | (2,414) |
| Net cash provided by operating activities | \$260,907 | \$6,420,723 |
| Cash Flows from Investing Activities: | | |
| Additions to property, plant and equipment | (1,923,220) | (352,132) |
| Purchase of investment securities | (11,199,339) | (8,922,097) |
| Proceeds from sale/maturity of investment securities | 9,102,457 | 5,071,818 |
| Net cash used in investing activities | (4,020,102) | (4,202,411) |
| Cash Flows from Financing Activities: | | |
| Dividends paid on common stock | (2,329,593) | (2,307,445) |
| Purchase of treasury stock | (109,694) | (44,335) |
| Proceeds from exercise of stock options | 439,115 | 150,917 |
| Excess tax benefits from share-based compensation | — | 9,070 |
| Net cash used in financing activities | (2,000,172) | (2,191,793) |
| (Decrease) increase in cash and cash equivalents | (5,759,367) | 26,519 |
| Cash and cash equivalents, beginning of the year | 10,058,163 | 10,031,644 |
| Cash and cash equivalents, end of the year | \$4,298,796 | \$10,058,163 |

Supplemental Schedule of Cash Flow Information:

| | | |
|-------------------|-----------|-----------|
| Income taxes paid | \$920,000 | \$323,000 |
|-------------------|-----------|-----------|

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

15

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 across the United States and at some international locations.

Note 2. Summary of Significant Accounting Policies

Revenue Recognition

The Company recognizes revenue in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605 "Revenue Recognition". Product sales represent the majority of the Company's revenue. The Company recognizes revenue from these product sales when persuasive evidence of an arrangement exists, transfer of title and risk of loss has occurred, the sale price is fixed or determinable, and collectability is reasonably assured. The Company sells its products on terms which transfer title and risk of loss at a specified location, typically shipping point. Accordingly, revenue recognition from product sales occurs when all factors are met. If these conditions are not met, the Company will defer revenue recognition until such time as these conditions have been satisfied. The Company collects and remits sales taxes in certain jurisdictions and reports revenue net of any associated sales taxes. The provision for product returns and price adjustments is assessed for adequacy at each quarter end and is based on recent historical experience and known customer claims and was not material as of June 30, 2018 or 2017.

A portion of our revenue, primarily for development contracts, is recognized using the milestone method of accounting. Each milestone for which revenue is recognized is considered substantive. In determining this the Company considered whether the consideration associated with the milestone was commensurate with the performance to achieve the milestone, relates solely to past performance, and reasonable relative to the other deliverables and payment terms within the agreement.

Inventory Valuation and Cost Estimation

Raw materials are valued at the lower of cost (average cost) or net realizable value. Balances for slow-moving and obsolete inventory are reviewed on a regular basis by analyzing estimated demand, inventory on hand, sales levels, market conditions, and other information and reduce inventory balances based on this analysis.

Inventoried work relating to contracts in process and work in process is valued at actual production cost, including factory overhead incurred to date. Contract costs include material, subcontract costs, labor, and an allocation of

overhead costs. 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. Provision for losses on contracts is made when the existence of such losses becomes probable and estimable. The provision for losses on contracts is included in other accrued expenses on the Company's balance sheet. 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.

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 |

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

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

Income Taxes

The Company follows the provisions of Accounting Standards Codification (“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.

Cash and Cash Equivalents

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

Investment Securities

The Company accounts for its investment securities in accordance with ASC 320-10-25, “Accounting for Certain Investments in Debt and Equity Securities.” Investment securities at June 30, 2018 and 2017 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, and are therefore considered a Level 1 valuation.

Fair Value of Financial Instruments

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.

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, 2018 and 2017 because of the immediate or short-term maturity of these financial instruments.

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. Interest is not charged on past due balances. Based on these factors, there was an allowance for doubtful accounts of \$3,000 at June 30, 2018 and 2017. 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 (EPS)" 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.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

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

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income for fiscal years ended June 30, 2018 and 2017 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. Unused credits are reflected as a deferred tax asset.

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 ASU No. 2014-09, “Revenue from Contracts with Customers,” which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU No. 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 No. 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.

In subsequent periods, the FASB issued additional ASUs intended to clarify specific aspects related to the interpretation and implementation of ASU No. 2014-09. In March 2016, the FASB issued ASU No. 2016-08, “Revenue from Contracts with Customers – Principal versus Agent Considerations (Reporting Revenue Gross versus Net)” to provide guidance on principal versus agent considerations by an entity as discussed in ASU No. 2014-09. ASU No. 2016-08 provides criteria to be assessed by an entity when determining whether it is the principal or agent in relation to the goods or services which the Company is contractually obligated to provide to the customer. Among these considerations are: identifying the unit of account at which the entity should assess whether it is a principal or an agent; identifying the nature of the good or service provided to the customer; applying the control principle to certain types of transactions; and, interaction of the control principle with the indicators provided to assist in the principle versus agent evaluation. In April 2016, the FASB issued ASU No. 2016-10, “Revenue from Contracts with Customers – (Topic 606): Identifying Performance Obligations and Licensing” to provide implementation guidance related to the necessary judgements required in identifying performance obligations of a contract and guidance related to recognition of licensing revenues. In May 2016, the FASB issued ASU No. 2016-12, “Revenue from Contracts with Customers – (Topic 606): Narrow-Scope Improvements and Practical Expedients” to provide guidance related to the implementation of ASU No. 2014-09 in the following areas; assessing collectability for contracts that do not meet Step 1 of revenue recognition, presentation of sales taxes, noncash consideration, contract modifications at transition, and completed contracts at transition.

These standards are effective for annual periods beginning after December 15, 2017, 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 No. 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). Early adoption is permitted for annual periods beginning after December 15, 2016 and interim periods therein. We evaluated the impact of adopting of ASU No. 2014-09; this will not have a material impact on the Company’s financial statements aside from increased disclosures. The Company used the modified retrospective method when adopting the standard beginning July 1, 2018.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

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

In July 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2015-11, “Inventory (Topic 330): Simplifying the Measurement of Inventory.” ASU No. 2015-11 requires inventory measured using any method other than last-in, first out or the retail inventory method to be subsequently measured at the lower of cost and net realizable value, rather than at the lower of cost or market. Net realizable value is defined as the estimated selling price, less the estimated costs to complete, dispose, and transport such inventory. ASU No. 2015-11 was effective for fiscal years and interim periods beginning after December 15, 2016. ASU No. 2015-11 was required to be applied prospectively and early adoption was permitted. The Company adopted ASU No. 2015-11 and it did not have a material impact on the Company’s financial position or results of operations.

In November 2015, the FASB issued ASU No. 2015-17, “Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes”. The guidance requires the classification of deferred tax assets and liabilities as non-current in a classified balance sheet. The current requirement that deferred tax assets and liabilities of a tax-paying component of an entity be offset and presented as a single amount is not affected by this update. We adopted ASU 2015-17 during the first quarter of fiscal year 2018 on a prospective basis. Prior periods were not retrospectively adjusted. Accordingly, for the twelve-month period ended June 30, 2018 we decreased current deferred tax assets by \$310,650 netted against noncurrent deferred tax liabilities of \$328,343; resulting in a noncurrent deferred tax liability balance of \$17,693. Adoption of ASU No. 2015-17 for the prior period presented would have the following impact on the Company’s financial statements for June 30, 2017; a decrease in current assets of \$317,559, a decrease in non-current liabilities of \$220,571 and an increase in non-current assets of \$96,988.

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities”. The amendments in this Update address certain aspects of recognition, measurement, presentation and disclosure of financial instruments (primarily equity securities) in order to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. ASU No. 2016-01 will be effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. The Company will be adopting ASU No. 2016-01 and it will not have a material impact on the Company's financial statements.

In March 2016, the FASB issued ASU No. 2016-09, “Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting”. The areas for simplification in this update involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. We adopted ASU 2016-09 during the first quarter of fiscal year 2018 on a prospective basis. We have elected to follow an accounting policy to estimate the number of awards that are expected to vest (consistent with ASU and prior GAAP). Adoption of ASU No. 2016-09 resulted in certain tax benefits of equity transactions being shown in the tax provision rather than in equity. The adoption of the ASU did not have a material impact on the Company’s financial statements.

In February 2018, the FASB issued ASU No. 2018-02, “Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income”. Under current accounting guidance, the income tax effects for changes in income tax rates and certain other transactions are recognized in income from continuing operations resulting in income tax effects recognized in Accumulated Other Comprehensive Income that do not reflect the current tax rate of the entity (“stranded tax effects”). The new guidance allows the Company the option to reclassify these stranded tax effects to retained earnings that relate to the change in the federal tax rate resulting from the passage of the Tax Cuts and Jobs Act (the “Tax Act”). This update is effective for fiscal years beginning after December 15, 2018, including interim periods therein, and early adoption is permitted. The Company is evaluating the impact that ASU No. 2018-02 will have on the Company's financial statements.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

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

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. There were no impairments of long-lived assets in fiscal years 2018 and 2017. 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, if applicable.

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 Securities

Investment securities at June 30, 2018 and 2017 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, 2018 and 2017 are as follows:

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| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <u>2018</u> | | | | |
| Certificates of deposit | \$ 10,440,000 | \$ — | \$ — | \$ 10,440,000 |
| Municipal bonds | 1,085,754 | 635 | (5,683) | 1,080,706 |
| 2018 Total investment securities | \$ 11,525,754 | \$ 635 | \$ (5,683) | \$ 11,520,706 |
| <u>2017</u> | | | | |
| Certificates of deposit | \$ 8,557,000 | \$ — | \$ — | \$ 8,557,000 |
| Municipal bonds | 871,872 | 258 | (2,162) | 869,968 |
| 2017 Total investment securities | \$ 9,428,872 | \$ 258 | \$ (2,162) | \$ 9,426,968 |

The portfolio is diversified and highly liquid and primarily consists of investment grade fixed income instruments. At June 30, 2018, the Company did not have any investments in individual securities that have been in a continuous loss position considered to be other than temporary.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

Note 3. Investment Securities, *Continued*

As of June 30, 2018 and 2017, the remaining contractual maturities of available-for-sale securities were as follows:

| | Years to Maturity | | |
|--------------------|-----------------------|-------------------------|---------------|
| | Less than One Year | One to Five Years | Total |
| 2018 | | | |
| Available-for-sale | \$ 10,967,300 | \$ 553,406 | \$ 11,520,706 |
| 2017 | | | |
| Available-for-sale | \$ 8,829,542 | \$ 597,426 | \$ 9,426,968 |

Note 4. Contracts in Process

Contracts in process at June 30, 2018 and 2017 are as follows:

| | 2018 | 2017 |
|---|--------------|--------------|
| Unrecognized gross contract value | \$48,100,984 | \$43,140,921 |
| Costs related to contracts in process, net of progress payments of \$102,924 and \$1,366,504 at June 30, 2018 and 2017, respectively | \$8,777,079 | \$7,863,538 |

Included in costs relating to contracts in process at June 30, 2018 and 2017 are costs of \$1,597,739 and \$1,635,661, 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 statements of comprehensive income until the units under contract are shipped.

Note 5. Property, Plant and Equipment

Property, plant and equipment at June 30, 2018 and 2017 is as follows:

| | 2018 | 2017 |
|------------------------------------|--------------|--------------|
| Land | \$45,000 | \$45,000 |
| Building and improvements | 4,378,866 | 4,304,366 |
| Machinery and equipment | 10,877,555 | 9,028,835 |
| Furniture and fixtures | 170,120 | 170,120 |
| | 15,471,541 | 13,548,321 |
| Accumulated depreciation | (11,712,904) | (11,283,225) |
| Property, plant and equipment, net | \$3,758,637 | \$2,265,096 |

Machinery and equipment includes \$763,367 that was not placed in service as of June 30, 2018. Depreciation expense was \$429,679 and \$435,557 for the years ended June 30, 2018 and 2017, respectively.

Note 6. Pension Expense

Under terms of a negotiated union contract which expires on June 30, 2022, 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 \$99,031 in fiscal year 2018 and \$89,023 in fiscal year 2017. These contributions represent more than five percent of the total contributions made into the Plan. For the years beginning January 1, 2018 and 2017, the Plan was in the “green zone” which means it is neither endangered nor critical status. A Funding Improvement Plan, entered into by Plan Trustees in fiscal year 2013, when the Plan was in “critical status,” calls for an increase in contributions starting January 1, 2016 of \$0.04 per hour for each year for five years thereafter. The increase did not and will not have a material impact on the Company’s financial statements.

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 \$52,225 and \$49,247, for fiscal years 2018 and 2017, respectively.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

Note 7. Provision for Income Taxes

The Tax Cuts and Jobs Act ("Tax Act") was enacted on December 22, 2017. The legislation significantly changes U.S. tax law by, among other things, lowering the U.S. federal corporate tax rate, bonus depreciation that allows for full expensing of qualified property, and limiting the deductibility of interest expense and executive compensation. The Tax Act permanently reduces the U.S. corporate income tax rate to a flat 21% rate, effective January 1, 2018. Pursuant to Section 15 of the Internal Revenue Code, the Company applied a blended corporate tax rate of 28.1 percent for fiscal year 2018, which was based on the applicable tax rates before and after the Tax Reform Act and the number of days in the year.

The Company re-measured certain U.S. deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%, and provisionally recorded an increase to the provision for income taxes of \$35,200 related to the re-measurement in the second quarter of fiscal year 2018. However, as of June 30, 2018 the impact from the Tax Act related to the re-measurement of the company's deferred tax assets and liabilities was a \$4,553 increase to the provision for income taxes. The year-end amount differed from the provisional amount booked in the second quarter due to variances in timing adjustments from those forecasted, mainly the accelerated expensing of property, plant and equipment placed in service in the third and fourth quarter.

A summary of the components of the provision for income taxes for the years ended June 30, 2018 and 2017 is as follows:

| | 2018 | 2017 |
|---------------------------------------|-----------|-----------|
| Current tax expense - federal | \$880,213 | \$559,171 |
| Current tax (benefit) expense - state | (2,009) | 2,986 |
| Deferred tax expense (benefit) | 115,075 | (46,488) |
| Provision for income taxes | \$993,279 | \$515,669 |

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 24.4% and 31.2%, for 2018 and 2017 respectively, differed from the statutory U.S. federal income tax rate for the following reasons:

| | 2018 | 2017 |
|--|--------|--------|
| U.S. federal statutory income tax rate | 28.1 % | 34.0 % |
| Increase (reduction) in rate resulting from: | | |
| State franchise tax, net of federal income tax benefit | (0.1) | 0.1 |
| ESOP cost versus Fair Market Value | 1.1 | 3.6 |
| Dividend on allocated ESOP shares | (2.9) | (7.2) |
| Qualified production activities | (2.1) | (2.8) |
| Stock-based compensation | 0.1 | 1.8 |

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| | | |
|--------------------|-------|-------|
| Other | 0.2 | 1.7 |
| Effective tax rate | 24.4% | 31.2% |

For the years ended June 30, 2018 and 2017 deferred income tax expense (benefit) of \$115,075 and (\$46,488), respectively, results 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, 2018 and 2017 are presented as follows:

| | 2018 | 2017 |
|--|------------|-----------|
| Deferred tax assets: | | |
| Accrued expenses | \$203,150 | \$195,915 |
| ESOP | 32,875 | 73,696 |
| Stock-based compensation | 51,140 | 81,659 |
| Inventory - effect of uniform capitalization | 53,863 | 36,935 |
| Unrealized loss (gain) on investment securities | 1,060 | 666 |
| Other | 1,437 | 2,384 |
| Total deferred tax assets | \$343,525 | \$391,255 |
| Deferred tax liability: | | |
| Property, plant and equipment - principally due to differences in depreciation methods | \$361,218 | \$294,267 |
| Total deferred tax liability | 361,218 | 294,267 |
| Net deferred tax (liability) asset | \$(17,693) | \$96,988 |

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 No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109, the Company recognized no material adjustments to unrecognized tax benefits. As of June 30, 2018 and 2017, the Company has no unrecognized tax benefits.

The Company recognizes interest and penalties in general and administrative expense. As of June 30, 2018 and 2017, the Company has not recorded any provision for accrued interest and penalties.

By federal and state tax statute, federal and state tax returns are subject to audit for three years from date of filing, unless the return was audited within that period. As such, federal returns for tax years ending June 30, 2018, 2017, 2016, and 2015 remain open to examination by the IRS. State returns for tax years ending June 30, 2018, 2017, 2016 and 2015 remain open to examination by the State of New York.

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 accounted for approximately 60% of total sales in fiscal year 2018. Sales to two domestic customers accounted for approximately 45% of total sales in fiscal year 2017.

Export sales in fiscal years 2018 and 2017 were approximately \$3,112,000 and \$1,730,000, 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 \$387,882 and \$417,419 for the years ended June 30, 2018 and 2017, respectively. The ESOP shares as of June 30, 2018 and 2017 were as follows:

| | 2018 | 2017 |
|---------------------------------|-----------|-------------|
| Allocated shares | 459,032 | 456,099 |
| Unreleased shares | 29,166 | 45,000 |
| Total shares held by the ESOP | 488,198 | 501,099 |
| Fair value of unreleased shares | \$782,524 | \$1,008,900 |

The Company may at times be required to repurchase shares at the ESOP participants' request at the fair market value. During the twelve months ended June 30, 2018, the Company repurchased 4,798 shares previously held in the ESOP for \$109,694. During the twelve months ended June 30, 2017 the Company repurchased 1,663 shares previously held by the ESOP for \$44,335.

The ESOP allows for eligible participants to take whole share distributions from the plan on specific dates in accordance with the provision of the plan. Share distributions from the ESOP during the twelve months ended June 30, 2018 and 2017 totaled 8,103 shares and 0 shares, respectively.

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 statements of comprehensive income for the fiscal years ended June 30, 2018 and 2017, was \$123,112 and \$129,167, respectively, before income taxes. The amount of this stock-based compensation expense related to non-qualified stock options ("NQSO") for the fiscal years ended June 30, 2018 and 2017, was \$32,564 and \$34,136, respectively. The total deferred tax benefit related to the NQSO's as of June 30, 2018 and 2017 was approximately \$6,839 and \$11,606, respectively. The remaining stock option expense in each year related to incentive stock options ("ISO") which are not deductible by the corporation when exercised, assuming a

qualifying disposition and as such no deferred tax benefit was established related to these amounts.

As of June 30, 2018, there was approximately \$129,983 of unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over the next 2.0 years, of which \$31,923 relates to NQSO's and \$98,060 relates to ISO's. The total deferred tax benefit related the NQSO's in future years will be approximately \$6,704.

The Company has one employee stock option plan under which options or stock awards may be granted, the 2017 Stock Option and Restricted Stock Plan (the "2017 Plan"), approved by the Company's shareholders at the Company's Annual Meeting on December 1, 2017. The Board of Directors may grant options to acquire shares of common stock to employees and non-employee directors of the Company at the fair market value of the common stock on the date of grant. The maximum aggregate number of shares of Common Stock subject to options or awards to non-employee directors is 133,000 and the maximum aggregate number of shares of Common Stock subject to options or awards granted to non-employee directors during any single fiscal year is the lesser of 13,300 and 33 1/3% of the total number of shares subject to options or awards granted in such fiscal year. The maximum number of shares subject to options or awards granted to any individual employee may not exceed 15,000 in a fiscal year. 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. Options covering 400,000 shares are authorized for issuance under the 2017 plan, of which 54,715 have been granted as of June 30, 2018. While no further grants of options may be made under the Company's 2007 Stock Option and Restricted Stock Plan, as of June 30, 2018, 171,949 options were outstanding under such plan of which 135,249 are vested and exercisable.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

Note 11. Stock-based Compensation, *Continued*

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

The table below outlines the weighted average assumptions that the Company used to calculate the fair value of each option award for the year ended June 30, 2018 and 2017.

| | 2018 | 2017 |
|---|---------|---------|
| Dividend yield | 4.54 % | 3.85 % |
| Expected stock price volatility | 24.07% | 29.70% |
| Risk-free interest rate | 2.04 % | 1.84 % |
| Expected option life (in years) | 4.8 yrs | 4.6 yrs |
| Weighted average fair value per share of options granted during the period | \$2.95 | \$4.64 |

The Company pays dividends quarterly and paid cash dividends totaling \$1.00 per share for the twelve months ended June 30, 2018 and 2017. 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, 2018:

| | 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, 2017 | 197,800 | \$ 24.57 | 5.86 | |
| Granted | 54,715 | \$ 22.14 | 9.32 | |
| Exercised | (20,601) | \$ 21.32 | — | |
| Forfeited or expired | (9,060) | \$ 24.25 | — | |
| Outstanding at June 30, 2018 | 222,854 | \$ 24.29 | 6.26 | \$581,319 |
| Vested or expected to vest at June 30, 2018 | 209,754 | \$ 24.31 | 6.09 | \$541,996 |
| Exercisable at June 30, 2018 | 135,249 | \$ 24.56 | 4.52 | \$316,848 |

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 American on June 30, 2018 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, 2018. 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, 2018 and 2017 was \$26,691 and \$20,769, respectively.

The following table summarizes changes in non-vested stock options during the twelve months ended June 30, 2018:

| | Weighted Number of Shares Subject to Option | Average Grant Date Fair Value (per Option) |
|-----------------------------|--|--|
| Non-Vested at July 1, 2017 | 42,900 | \$ 4.59 |
| Granted | 54,715 | 2.92 |
| Vested | (3,000) | 3.87 |
| Forfeited or expired | (7,010) | 3.64 |
| Non-Vested at June 30, 2018 | 87,605 | \$ 3.65 |

Note 12. Concentration of Credit Risk

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 one customer at June 30, 2018 and 41% represented by two customers at June 30, 2017.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

Note 12. Concentration of Credit Risk, *Continued*

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 Amended and Restated Plan and a Trust Agreement, each effective as of July 1, 2016. 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 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, 2018 and 2017. 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.

We are party to various litigation matters and claims arising from time to time in the ordinary course of business. While the results of such matters cannot be predicted with certainty, we believe that the final outcome of such matters will not have a material adverse effect on our business, financial condition, results of operations or cash flows.

Note 15. Stockholders' Equity

Reservation of Shares

The Company has reserved common shares for future issuance as follows as of June 30, 2018:

| | |
|--------------------------------------|---------|
| Stock options outstanding | 222,854 |
| Stock options available for issuance | 349,095 |
| Number of common shares reserved | 571,949 |

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

Note 15. Stockholders' Equity, *Continued*

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

| | 2018 | 2017 |
|--|-------------|-------------|
| Numerator: | | |
| Net income | \$3,075,797 | \$1,135,736 |
| Denominator: | | |
| Basic EPS: | | |
| Common shares outstanding, beginning of period | 2,371,321 | 2,364,684 |
| Unearned ESOP shares | (45,000) | (61,667) |
| Weighted average common shares issued during the period | 4,685 | 4,465 |
| Weighted average common shares purchased during the period | (3,075) | (879) |
| Weighted average ESOP shares earned during the period | 5,954 | 6,267 |
| Denominator for basic earnings per common shares – Weighted average common shares | 2,333,885 | 2,312,870 |
| Diluted EPS: | | |
| Common shares outstanding, beginning of period | 2,371,321 | 2,364,684 |
| Unearned ESOP shares | (45,000) | (61,667) |
| Weighted average common shares issued during the period | 4,685 | 4,465 |
| Weighted average common shares purchased during the period | (3,075) | (879) |
| Weighted average ESOP shares earned during the period | 5,954 | 6,267 |
| Weighted average dilutive effect of stock options | 14,422 | 11,968 |
| Denominator for diluted earnings per common shares – Weighted average common shares | 2,348,307 | 2,324,838 |

Not included in this computation of earnings per share for the year ended June 30, 2018 and 2017 were options to purchase 2,500 and 151,800 shares, respectively, 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.

The Company paid cash dividends on common stock of \$1.00 per share for the fiscal year ended June 30, 2018 and 2017. Subsequent to June 30, 2018, the Board of Directors has authorized the payment of a fiscal year 2019 first quarter regular dividend of \$0.25, and a special dividend of \$1.00, payable October 1, 2018 to shareholders of record on September 24, 2018. 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.

Note 16. Line of Credit

At June 30, 2018, 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 in November for renewal on December 1st. All outstanding balances are payable no later than the expiration date of the agreement, unless other terms are agreed to by the lender.

Espey Mfg. & Electronics Corp.

Notes to Financial Statements

Note 17. Quarterly Financial Information (Unaudited)

| | First | Second | Third | Fourth |
|------------------------|-------------|--------------|-------------|-------------|
| | Quarter | Quarter | Quarter | Quarter |
| 2018 | | | | |
| Net sales | \$7,496,423 | \$11,531,105 | \$5,663,161 | \$7,827,194 |
| Gross profit | 1,461,154 | 3,075,598 | 1,255,204 | 1,870,296 |
| Net income | 442,764 | 1,614,871 | 317,764 | 700,398 |
| Net income per share - | | | | |
| Basic | 0.19 | 0.69 | 0.14 | 0.30 |
| Diluted | 0.19 | 0.69 | 0.14 | 0.29 |
| 2017 | | | | |
| Net sales | \$6,068,684 | \$5,667,624 | \$5,324,104 | \$5,460,600 |
| Gross profit | 1,343,748 | 1,080,145 | 1,128,505 | 1,162,170 |
| Net income | 420,825 | 244,079 | 279,173 | 191,659 |
| Net income per share - | | | | |
| Basic | 0.18 | 0.11 | 0.12 | 0.08 |
| Diluted | 0.18 | 0.11 | 0.12 | 0.08 |

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
None

Item 9A. Controls and Procedures
Evaluation of 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 Annual Report on Form 10-K. 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.

Management's Report on Internal Control over Financial Reporting

Management of our Company is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including the principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting using the criteria set forth in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. Based on our evaluation using the criteria set forth in Internal Control-Integrated Framework, management has concluded that our internal control over financial reporting was effective as of June 30, 2018.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Our report was not subject to attestation by our registered public accounting firm pursuant to rules of the SEC that permit us to provide only management's report in this annual report.

Item 9B. Other information
None

PART III

The information called for by "Item 10. Directors, Executive Officers, and Corporate Governance", "Item 11. Executive Compensation", "Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters", "Item 13. Certain Relationships and Related Transactions, and Director Independence" and "Item 14. Principal Accountant Fees and Services", is hereby incorporated by reference to the Company's Proxy Statement for its Annual Meeting of Shareholders, (scheduled to be held on December 7, 2018) to be filed with the SEC pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended.

PART IV

Item 15. Exhibits, Financial Statement Schedules, Signatures

3.1 Certificate of incorporation and all amendments thereto (incorporated by reference to Exhibit 3.1 to Espey's Report on Form 10 -K for the year ended June 30, 2004 and Report on Form 10-Q for the quarter ended December 31, 2004)

3.2 Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2 to Espey's Report on Form 8 -K dated February 26, 2009)

4.1 Second Amended and Restated Rights Agreement, dated December 18, 2009, between Espey Mfg. & Electronics Corp. and Registrar and Transfer Company (incorporated by reference to Exhibit 4.01 to Espey's Report on Form 8-K dated December 18, 2009)

4.2 Description of Capital Stock (incorporated by reference to Espey's Report on Form 8-K dated October 7, 2005)

10.3 2007 Stock Option and Restricted Stock Plan (incorporated by reference to Espey's Proxy Statement dated October 23, 2007 for the November 30, 2007 Annual Meeting)

10.4 2017 Stock Option and Restricted Stock Plan (incorporated by reference to Espey's Proxy Statement dated October 27, 2017 for the December 1, 2017 Annual Meeting)

10.5 Retired Director Compensation Program and Mandatory Retirement Agreement (amended effective June 2, 2017) (incorporated by reference to Espey's Report on Form 10-K dated September 14, 2017 for the year ended June 30, 2017)

10.6 Director Contingent Severance Compensation Agreement - Paul J. Corr dated March 2, 2018 (incorporated by reference to Espey's Report on Form 8-K dated March 2, 2018)

10.7 Director Contingent Severance Compensation Agreement – Carl Helmetag dated March 2, 2018 (incorporated by reference to Espey's Report on Form 8-K dated March 2, 2018)

10.8 Retired Director Compensation Program and Mandatory Retirement Agreement – Barry Pinsley (incorporated by reference to Exhibit 10.8 to Espey's Report on Form 10-Q dated May 12, 2011) and (incorporated by reference to Exhibit 10.5 to Espey's Report on Form 10-K dated September 14, 2017 for the year end June 30, 2017)

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- 10.9 Director Contingent Severance Compensation Agreement – Howard Pinsley dated March 2, 2018 (incorporated by reference to Epsey’s Report on Form 8-K dated March 2, 2018)
- 10.10 Director Contingent Severance Compensation Agreement – Alvin Sabo dated March 2, 2018 (incorporated by reference to Epsey’s Report on Form 8-K dated March 2, 2018)
- 10.11 Director Contingent Severance Compensation Agreement – Michael Wool dated March 2, 2018 (incorporated by reference to Epsey’s Report on Form 8-K dated March 2, 2018)
- 10.13 Executive Employment Agreement with David O’Neil (incorporated by reference to Exhibit 10.13 on Epsey’s Report on Form 8 –K dated March 4, 2013)
- 10.14 Executive Employment Agreement with Peggy Murphy (incorporated by reference to Exhibit 10.14 on Epsey’s Report on Form 8 –K dated March 4, 2013)
- 10.16 Employment Agreement dated January 16, 2018 with Patrick Enright, Jr. (incorporated by reference to Exhibit 10.16 on Epsey’s Report on Form 8-K dated January 16, 2018)
- 10.17 Settlement Agreement dated July 31, 2018, by and among Epsey Mfg. & Electronics Corp., The Article 6 Marital Trust Under The First Amended and Restated Jerry Zucker Revocable Trust Dated April 2, 2007, and Paul J. Corr, Michael W. Wool, Barry Pinsley, Carl Helmetag, Howard Pinsley, and Alvin O. Sabo. (incorporated by reference to Exhibit on 10.16 on Epsey’s Report on Form 8-K dated July 31, 2018)

11.1 Statement re: Computation of Per Share Net income (filed herewith)

14.1 Code of ethics (incorporated by reference to Epsey’s website www.espey.com)

23.1

Consent of Freed Maxick CPAs, P.C. (filed herewith)

- 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 (filed herewith)
- 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 (filed herewith)
- 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 (filed herewith)
- 32.2 Certification of the Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

31

SIGNATURES

Pursuant to the requirements of Section 13 and 15 (d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ESPEY MFG. & ELECTRONICS CORP.

/s/Patrick Enright Jr.
Patrick Enright Jr.
President and Chief Executive Officer
September 12, 2018

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/Patrick Enright Jr. President and Chief Executive Officer
Patrick Enright Jr. September 12, 2018

/s/David O'Neil Principal Financial Officer and Executive Vice President
David O'Neil September 12, 2018

/s/Katrina Sparano Assistant Treasurer
Katrina Sparano September 12, 2018

/s/Howard Pinsley Chairman of the Board
Howard Pinsley September 12, 2018

/s/Barry Pinsley Director
Barry Pinsley September 12, 2018

/s/Michael W. Wool Director

Michael W. Wool September 12, 2018

/s/Paul J. Corr Director
Paul J. Corr September 12, 2018

/s/Carl Helmetag Director
Carl Helmetag September 12, 2018

/s/Roger Sexauer Director
Roger Sexauer September 12, 2018

/s/ Alvin Sabo Director
Alvin Sabo September 12, 2018