ESPEY MFG & ELECTRONICS CORP
Form 10KSB
September 25, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-KSB

[X] Annual Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the fiscal year ended June 30, 2006

[ ] Transition Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934. For the transition period from to

Commission File No. 1-4383

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

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

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

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

Title of Each class	Name of Each Exchange on Which Registered
Common Stock $.33-1/3 par value	American Stock Exchange
Common Stock Purchase Rights	American Stock Exchange

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

Indicate by check mark whether the registrant (1) has filed all reports required to the filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.
[X] Yes [ ] No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B 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-KSB or any amendment to this Form 10-KSB.
[X] Yes [ ] No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).
[ ] Yes [X] No

Revenues for fiscal year ended June 30, 2006 were $20,851,570.

The aggregate market value of the voting stock held by non-affiliates of the registrant was $23,397,251 based upon the closing sale price of $16.70 on the American Stock Exchange on June 30, 2006.

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

Class	Outstanding at September 25, 2006
Common stock, $.33-1/3 par value	2,309,396 shares

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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrants definitive proxy statement relating to the 2006 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-KSB as indicated herein.

Forward-Looking Statements

This Annual Report on Form 10-KSB 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 in the U.S. government's defense budget (including changes in priorities in response to terrorist threats or to improve homeland security);
- 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 for changing prices for energy and raw materials.

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

PART I

Item 1. Business

General

Espey Mfg. & Electronics Corp. (the "Company") located in Saratoga Springs, New York, is engaged principally in the development, design, production and sale of specialized electronic power supplies, a wide variety of transformers and other types of iron-core components, and electronic system components. In some cases, the Company manufactures such products in accordance with pre-developed mechanical and electrical requirements ("build to print"). In other cases, the Company is responsible for both the overall design and manufacture of the product. The Company does not generally manufacture standardized components. The Company operates a one-segment business and was incorporated in 1928.

The electronic power supplies and components manufactured by the Company find application principally in (i) shipboard and land based radar, (ii) locomotives, (iii) aircraft, (iv) short and medium range communication systems, (v) navigation systems and (vi) land based military vehicles.

The Company's iron-core components include (i) transformers of the audio, power and pulse types, (ii) magnetic amplifiers and (iii) audio filters. The electronic system components manufactured by the Company include antenna systems and high power radar transmitters. These system components utilize the Company's own electronic power supplies, transformers and other iron-core components and mechanical assemblies.

In the fiscal years ended June 30, 2006 and 2005, the Company's total sales were $20,851,570 and $18,828,700, respectively. Sales to three domestic customers accounted for 35%, 17% and 13% of total sales in 2006. Sales to two domestic customers accounted for 32% and 14% of total sales in 2005.

Export sales in 2006 and 2005 were approximately $3,392,000 and $4,946,000, respectively.

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Sources of Raw Materials

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

Sales Backlog

At September 21, 2006, the Company's backlog was approximately $36.5 million. The total backlog at June 30, 2006 was approximately $37.7 million as compared to approximately $31.8 million at June 30, 2005. The Company's total backlog represents the estimated remaining sales value of work to be performed under firm contracts. The Company's backlog and risks associated with government contracts is discussed in greater detail in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 7 below.

It is presently anticipated that a minimum of $24 million of orders comprising the June 30, 2006 backlog will be filled during the fiscal year ending June 30, 2007. The minimum of $24 million does not include any shipments, which may be made against orders subsequently received during the fiscal year ending June 30, 2007. The estimate of the June 30, 2006 backlog to be shipped in fiscal 2007 is subject to future events, which may cause the amount of the backlog actually shipped to differ from such estimate.

Marketing and Competition

The Company markets its products primarily through its own direct sales organization. Business is solicited from large industrial manufacturers and defense companies, the government of the United States and foreign governments and major foreign electronic equipment companies. In certain countries the Company has external sales representatives to help solicit and coordinate foreign contracts. The Company is also on the eligible list of contractors of many agencies of the United States Department of Defense and generally is automatically solicited by such agencies for procurement needs falling within the major classes of products produced by the Company.

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

The Company's business is not considered to be seasonal in nature.

Research and Development

The Company's expenditures for research and development were approximately $121,000 and $187,000 in 2006 and 2005, respectively. Some of the Company's engineers and technicians spend varying degrees of time on either development of new products or improvement of existing products.

Employees

The Company had 175 employees as of September 21, 2006. Some of these employees are represented by the International Brotherhood of Electrical Workers Local #1799. The current collective bargaining agreement expires on June 30, 2008. The contract includes a 3.75% annual pay increase in the fiscal period 2006 through 2007, and no increase for 2008. Relations with the Union are considered good. Union membership at September 21, 2006 was 74 people.

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Government Regulations

Compliance with federal, state and local provisions that have been enacted or adopted to regulate the discharge of materials into the environment, or otherwise relating to the protection of the environment, did not in fiscal 2006, and the Company believes will not in fiscal year 2007, have a material effect upon the capital expenditures, net income, or competitive position of the Company.

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

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

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

U.S. Government Defense Contracts and Subcontracts

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

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

Item 2. Properties

The Company's manufacturing and engineering facilities are at its plant in Saratoga Springs, New York.

The Saratoga Springs plant, which the Company owns, consists of various adjoining one-story buildings on a 22 acre site. (Approximately 8% of this site is unimproved) The property is not subject to mortgage indebtedness or any other material encumbrance. The plant has a sprinkler system throughout and contains approximately 151,000 square feet of floor space, of which 90,000 is used for manufacturing, 24,000 for engineering, 33,000 for shipping and climatically secured storage, and 4,000 for offices. The offices, engineering and some manufacturing areas are air-conditioned. In addition to assembly and wiring operations, the plant includes facilities for varnishing, potting, plating, impregnation and spray-painting operations. The manufacturing operation also includes a complete machine shop, with welding and sheet metal fabrication facilities adequate for substantially all of the Company's current operations. Besides normal test equipment, the Company maintains a sophisticated on-site environmental test facility. In addition to meeting all of the Company's in-house needs, the plating, machine shop and environmental facilities are available to other companies on a contract basis.

Item 3. Legal Proceedings

None

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

None

PART II

Item 5. Market for the Registrant's Common Equity and Related Stockholder Matters

Price Range of Common Stock

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

2006	High	Low
First Quarter	17.88	15.05
Second Quarter	20.45	17.31
Third Quarter	18.95	15.00
Fourth Quarter	19.45	15.90
2005	High	Low
First Quarter	13.05	11.18
Second Quarter	14.45	12.80
Third Quarter	13.70	12.83
Fourth Quarter	15.88	12.38

As described in note 17 to the financial statements in Part II item 7, a stock split in the form of a stock dividend of one share of common stock for each share of common stock issued, was paid on December 30, 2005 (all per share and share amounts have been adjusted to reflect this dividend).

Holders

The approximate number of holders of record of the common stock was 118 on September 21, 2006 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 the common stock of $.34 and $.30 per share for the fiscal years ended June 30, 2006 and 2005, respectively. The Board of Directors has authorized the payment of a fiscal 2007 first quarter dividend of $.13 payable September 22, 2006.

During fiscal 2006 the Company sold common stock to certain employees as they exercised existing stock options granted under a shareholder approved plan. During the year, 23,200 shares were sold at prices that ranged from $6.63 a share to $11.25 a share. The securities were sold for cash. Proceeds are used for general working capital purposes.

There were no purchases of equity securities in the fiscal 2006 fourth quarter.

Securities Authorized For Issuance Under Equity Compensation Plans

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of Se available for f equity compensa securities ref
	(a)	(b)	
Equity compensation plans approved by security holders	146,200	14.02	
Equity compensation plans not approved by security holders	--	--	
Total	146,200		

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

Business Outlook

The business outlook for the Company is excellent. The order backlog remains high, in terms of Company revenues in recent years, as sales continue to increase. Also, expectations are for product mix and margins to remain favorable for fiscal 2007. During fiscal 2006 new orders received by the Company were approximately $26.9 million. The order backlog of approximately $37.7 million at June 30, 2006 gives the Company a solid base of future sales and, therefore, management expects a significant increase in sales during fiscal 2007, as compared to fiscal 2006. In addition to the backlog, the Company currently has outstanding quotations representing in excess of $26.6 million in the aggregate for both repeat and new programs. Many potential orders are currently being discussed and negotiated with existing and potential new customers.

The total order backlog was approximately $37.7 million at June 30, 2006, an increase of $5.9 million over June 30, 2005. The backlog represents the estimated remaining sales value of work to be performed under firm contracts. The funded portion of this backlog at June 30, 2006 is approximately $29.2 million. This includes items that have been authorized and appropriated by Congress and/or funded by the customer. The unfunded backlog is approximately $8.5 million and represents firm multi-year orders for which funding has not yet been appropriated by Congress. While there is no guarantee that future budgets and appropriations will provide funding for a given program, management has included in unfunded backlog only those programs that it believes are likely to receive funding. The unfunded backlog at June 30, 2005 was approximately $8.7 million.

The outstanding quotations encompass various new and previously manufactured power supplies, transformers, and subassemblies. However, there can be no assurance that the Company will acquire any or all of the anticipated orders described above, many of which are subject to allocations of the United States defense spending and factors affecting the defense industry and military procurement generally.

Results of Operations

Net Sales for fiscal years ended June 30, 2006 and 2005, were $20,851,570 and $18,828,700, respectively, a 10.7% increase. Generally, this increase can be attributed to the contract specific nature of the Company's business and the long-term nature of these contracts. The increase in order backlog that occurred during the last two quarters of fiscal 2005 began to be recognized in net sales in fiscal 2006. This trend is expected to continue into the next several quarters. The sales backlog at June 30, 2006, as discussed above, includes significant orders for military and industrial power supplies, and contracts to manufacture certain customer products in accordance with pre-engineered requirements.

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

For fiscal years ended June 30, 2006 and 2005 gross profits were $4,542,089 and $3,381,357, respectively. Gross profit as a percentage of sales was 21.8% and 18.0%, for fiscal 2006 and 2005, respectively. A favorable product mix, partially offset by higher ESOP compensation expense, caused the improved gross profit percentage in fiscal 2006. ESOP compensation expense included in cost of sales was $356,990 for the fiscal year ended June 30, 2006, and zero for the fiscal year ended June 30, 2005 (see note 11 to the financial statements). Management continues to evaluate the Company's workforce to ensure that production and overall execution of the backlog orders and additional anticipated orders are successfully performed. Employment at June 30, 2006 was 169 people, the same number employed at June 30, 2005.

Selling, general and administrative expenses were $2,636,458 for the fiscal year ended June 30, 2006, an increase of $362,432, or 15.9% as compared to the prior year. This increase is primarily due to an increase in the sales force and ESOP compensation expense, offset partially by a decrease in professional fees.

Other income for fiscal 2006 increased as compared to fiscal 2005 due to increased interest income on the Company's cash equivalents and short-term investments due to higher interest rates. The Company does not believe that there is significant risk associated with its investment policy, since at June 30, 2006 all of the investments were primarily represented by short-term liquid investments including certificates of deposit and money market accounts.

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The effective income tax rate was 34.2% in fiscal 2006 and 27.6% in fiscal 2005. The effective tax rate was less than the statutory tax rate in fiscal 2005 mainly due to the foreign exportation benefit the Company received on its international sales.

Net income for fiscal 2006, was $1,558,016 or $.77 and $.76 per share, basic and diluted, respectively, compared to net income of $978,920 or $.48 per share, for both basic and diluted, for fiscal 2005. The increase in net income per share was due to increased sales and improved gross profit margins offset by the increase in selling, general and administrative expenses.

Liquidity and Capital Resources

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

The Company's working capital as of June 30, 2006 and 2005 was $26,316,971 and $25,370,512, respectively. During 2006 and 2005 the Company repurchased 38,746 and 17,448 shares, respectively, of its common stock from the Company's Employee Retirement Plan and Trust ("ESOP") and in other open market transactions, for a total purchase price of $679,809 and $215,366, respectively. Under existing authorizations from the Company's Board of Directors, as of June 30, 2006, management is authorized to purchase an additional $320,191 of Company stock.

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

	2006	2005
Net cash (used in) provided by operating activities....	$ (309,778)	$ 710,049
Net cash (used in) provided by investing activities....	(5,667,338)	2,441,362
Net cash provided by financing activities	3,246,224	776,152

Net cash provided by operating activities fluctuates between periods primarily as a result of differences in net income, the timing of the collection of accounts receivable, purchase of inventory, receipt of progress payments, level of sales and payments of accounts payable. Net cash used in investing activities increased in fiscal 2006 due to the purchase of short-term investments and the ESOP transaction described in note 11. The increase in cash provided by financing activities is due primarily to the sale of treasury shares to the ESOP in the first half of fiscal 2006.

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

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

During fiscal year 2006 and fiscal 2005, the Company expended $468,868 and $425,362, respectively, for plant improvements and new equipment. The Company has budgeted approximately $400,000 for new equipment and plant improvements in fiscal 2007. Management presently anticipates that the funds required will be available from current operations.

The Company has entered into standby letters of credit agreements with financial institutions primarily relating to the guarantee of future performance on certain contracts. Contingent liabilities on outstanding standby letters of credit agreements aggregated $246,625 at June 30, 2006. The Company does not expect to fund any of the amounts under the standby letters of credit.

Critical Accounting Policies and Estimates

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

Revenue Recognition and Estimates

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

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

Other Matters

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

The Board of Directors of the Company approved a purchase price per share equal to a 5% discount on the average trading price of the Company's common stock on the American Stock Exchange on the date before closing, but in no event greater than the fair market value as determined by an independent valuation firm retained by the ESOP. The average trading price of the Company's common stock on the American Stock Exchange on July 14, 2005 was $30.72.

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

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

Item 7. Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firms

To the Board of Directors and Stockholders
Espey Mfg. & Electronics Corp.:

We have audited the accompanying balance sheet of Espey Mfg. & Electronics Corp. as of June 30, 2006, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Espey Mfg. & Electronics Corp. as of June 30, 2005, were audited by other auditors whose report dated August 12, 2005, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of June 30, 2006, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/Rotenberg & Co., LLP

Rochester, New York
August 3, 2006

The Board of Directors and Stockholders
Espey Mfg. & Electronics Corp.:

We have audited the accompanying statements of income, changes in stockholders' equity, and cash flows of Espey Mfg. & Electronics Corp. for the year ended June 30, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the results of operations and the cash flows of Espey Mfg. & Electronics Corp. for the year ended June 30, 2005, in conformity with U.S. generally accepted accounting principles.

/s/KPMG LLP

KPMG LLP
Albany, New York
August 12, 2005

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Espey Mfg. & Electronics Corp.
Balance Sheet
June 30, 2006

	2006
ASSETS	
Cash and cash equivalents	$ 7,072,615
Short term investments	3,936,000
Trade accounts receivable, net	4,213,228
Other receivables	6,884
Inventories:	
Raw materials and supplies	1,834,945
Work in Process	2,268,357
Costs related to contracts in process, net of progress payments of $234,154	8,301,077
Total inventories	12,404,379
Deferred income taxes	164,969
Prepaid expenses and other current assets	554,127
Total current assets	28,352,202
Property, plant and equipment, net	2,882,452
Total Assets	$ 31,234,654
LIABILITIES AND STOCKHOLDERS' EQUITY	
Accounts payable	$ 615,586
Accrued expenses:	
Salaries, wages and commissions	128,007
Vacation	545,423
Other	51,400
Payroll and other taxes withheld and accrued	40,597
Income taxes payable	654,218
Total current liabilities	2,035,231
Deferred income taxes	226,653
Total Liabilities	2,261,884
Common stock, par value $.33-1/3 per share	

Authorized 10,000,000 shares; Issued 3,029,874 shares in 2006. Outstanding 2,304,562 (includes 274,167 Unearned ESOP Shares)	1,009,958
Capital in excess of par value	12,506,749
Retained earnings	25,651,945
	39,168,652
Less: Unearned ESOP Shares	(3,961,079)
Cost of 725,312 shares of common stock in treasury	(6,234,803)
Total Stockholders' Equity	28,972,770
Total Liabilities and Stockholders' Equity	$ 31,234,654

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

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Espey Mfg. & Electronics Corp.
Statements of Income
Years Ended June 30, 2006 and 2005

	2006	2005
Net sales	$ 20,851,570	$ 18,828,700
Cost of sales	16,309,481	15,447,343
Gross Profit	4,542,089	3,381,357
Selling, general and administrative expenses	2,636,458	2,274,026
Operating income	1,905,631	1,107,331
Other income (expense)		
Interest and dividend income	464,143	228,159
Other	(3,220)	16,365
Total other income, net	460,923	244,524
Income before income taxes	2,366,554	1,351,855
Provision for income taxes	808,538	372,935
Net income	$ 1,558,016	$ 978,920
Net income per share:		
Basic	$ .77	$ .48
Diluted	$ .76	$ .48
Weighted average number of shares outstanding:		
Basic	2,012,761	2,021,234
Diluted	2,049,455	2,043,208

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, 2006 and 2005

	Outstanding Common Shares	$ Amount	Capital in Excess of Par Value	Unearned ESOP Shares
Balance as of June 30, 2004	2,029,236	$ 504,979	$ 10,411,915	$
Net income, 2005				
Stock options exercised	4,800		(12,460)	
Dividends paid on common stock $.30 per share				
Tax effect of stock options exercised			12,618	
Purchase of treasury stock	(17,448)			
Balance as of June 30, 2005	2,016,588	504,979	10,412,073	
Net income, 2006				
Stock options exercised	23,200		48,578	
Dividends paid on common stock $.3425 per share				
Stock dividend paid on common stock		504,979		
Sale of treasury stock to ESOP	303,520		1,973,781	(4,335,0
Purchase of treasury stock	(38,746)			
Reduction of Unearned ESOP Shares			72,317	373,9
Balance as of June 30, 2006	2,304,562	$ 1,009,958	$ 12,506,749	$ (3,961,0

	Treasury Stock Shares	Treasury Stock $ Amount	Total Stockholders' Equity
Balance as of June 30, 2004	1,000,638	$ (7,986,908)	$ 27,841,906
Net income, 2005			978,920
Stock options exercised	(4,800)	57,960	45,500
Dividends paid on common stock $.30 per share			(606,286)
Tax effect on stock options exercised			12,618
Purchase of treasury stock	17,448	(215,366)	(215,366)
Balance as of June 30, 2005	1,013,286	(8,144,314)	28,057,292
Net income, 2006			1,558,016
Stock options exercised	(23,200)	166,677	215,255
Dividends paid on common stock $.3425 per share			(685,646)
Stock dividend paid on common stock			--
Sale of treasury stock to ESOP	(303,520)	2,422,642	61,423
Purchase of treasury stock	38,746	(679,808)	(679,808)
Reduction of Unearned ESOP Shares			446,238
Balance as of June 30, 2006	725,312	$ (6,234,803)	$ 28,972,770

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

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Espey Mfg. & Electronics Corp.
Statements of Cash Flows
Years Ended June 30, 2006 and 2005

	2006	2005

Cash Flows From Operating Activities:		
Net income	$ 1,558,016	$ 978,920
Adjustments to reconcile net income to net cash provided by operating activities:		
Tax effect on stock options exercised	--	12,618
Depreciation	532,735	541,041
ESOP Compensation Expense	446,238	--
Loss on disposal of plant and equipment	37,988	--
Deferred income tax (benefit)	(100,376)	(85,380)
Changes in assets and liabilities:		
(Increase) decrease in trade receivables	(1,219,988)	(852,843)
(Increase) decrease in other receivables	(3,711)	(1,364)
(Increase) decrease in inventories, net	(2,036,827)	(282,255)
(Increase) decrease in prepaid expenses and other current assets	(218,132)	23,398
Increase (decrease) in accounts payable	236,815	128,096
Increase (decrease) in accrued salaries, wages and commissions	65,729	17,759
(Decrease) increase in accrued employee insurance costs	--	(7,487)
Increase (decrease) in vacation accrual	47,408	46,499
(Decrease) increase in other accrued expenses	(2,383)	3,413
Increase (decrease) in payroll and other taxes withheld and accrued	4,620	9,977
Increase (decrease) in income taxes payable	342,090	177,657
Net cash (used in) provided by operating activities	$ (309,778)	$ 710,049

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

(Continued)

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Cash Flows From Investing Activities:		
Unearned ESOP Shares	(4,335,000)	--

Additions to property, plant and equipment	(468,868)	(425,362)
Purchase of short term investments	(5,952,000)	(2,688,000)
Proceeds from maturity of short term investments	5,088,000	672,000
Proceeds on sale of assets, net	530	--
Net cash used in investing activities	(5,667,338)	(2,441,362)
Cash Flows From Financing Activities:		
Sale of Treasury Stock	4,396,423	--
Dividends on common stock	(685,646)	(606,286)
Purchase of treasury stock	(679,808)	(215,366)
Proceeds from exercise of stock options	215,255	45,500
Net cash provided by (used in) financing activities	3,246,224	(776,152)
Decrease in cash and cash equivalents	(2,730,892)	(2,507,465)
Cash and cash equivalents, beginning of the year	9,803,507	12,310,972
Cash and cash equivalents, end of the year	$ 7,072,615	$ 9,803,507
Income Taxes Paid	$ 591,345	$ 268,040

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

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 1. Nature of operations

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

Note 2. Summary of Significant Accounting Policies

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

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

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

Percentage of completion accounting requires judgment relative to expected sales, estimating costs and making assumptions related to technical issues and delivery schedule. Contract costs include material, subcontract costs, labor and an allocation of overhead costs. The estimation of cost at completion of a contract is subject to numerous variables involving contract costs and estimates as to the length of time to complete the contract. Given the significance of the estimation processes and judgments described above, it is possible that materially different amounts of contract costs could be recorded if different assumptions were used, based on changes in circumstances, in the estimation of cost at completion. 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 - 35 years
Machinery and equipment	3 - 25 years
Furniture, fixtures and office equipment	5 - 10 years

Income Taxes

The Company follows the provisions of Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes."

Under the provisions of SFAS No. 109, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred taxes and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. In addition, SFAS No. 109 requires that the tax benefit of tax-deductible dividends on unallocated ESOP shares be recorded as a direct addition to retained earnings rather than as a reduction of income tax expense.

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Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 2. Summary of Significant Accounting Policies, Continued

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

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

Stock-Based Compensation
The intrinsic value method of accounting is used for stock-based compensation plans. Under the intrinsic value method, compensation cost is measured as the excess, if any, of the quoted market price of the stock at the grant date over the amount an employee must pay to acquire the stock.

The Company has elected to account for its stock-based compensation plans under the intrinsic value-based method of accounting as permitted by SFAS No. 123 and as prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations including FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation - An Interpretation of APB No. 25", in accounting for its fixed stock option plans. Under this method, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. In December 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 148, "Accounting for Stock Based Compensation". SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation and amends the disclosure requirements of SFAS No. 123, "Accounting for Stock Based Compensation", to require more prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company adopted the disclosure requirements of SFAS No. 123 and SFAS No. 148, as required.

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

	Years Ended June 30, 2006	2005
Net income as reported	$ 1,558,016	$ 978,920
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(88,411)	(43,470)
Pro forma net income	$ 1,469,605	$ 935,450
Net income per share:		
Basic-as reported	$ 0.77	$ 0.48
Basic-pro forma	$ 0.73	$ 0.46

Diluted-as reported	$ 0.76	$ 0.48
Diluted-pro forma	$ 0.72	$ 0.46

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Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 2. Summary of Significant Accounting Policies, Continued

Per Share Amounts
SFAS 128 "Earnings Per Share" requires the Company to calculate net income (loss) per share based on basic and diluted net income (loss) per share, as defined. Basic EPS excludes dilution and is computed by dividing net income (loss) by the weighted average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The dilutive effect of outstanding options issued by the Company are reflected in diluted EPS using the treasury stock method. Under the treasury stock method, options will only have a dilutive effect when the average market price of common stock during the period exceeds the exercise price of the options.

Comprehensive Income
Comprehensive Income for the years ended June 30, 2006 and 2005 is equal to net income.

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

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

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

Recently Issued Accounting Standards
In November 2004, the FASB issued SFAS No. 151, "Accounting for Unexpected Production Defects and Waste." SFAS No. 151 requires that "abnormal freight, handling costs, and amounts of wasted materials (spoilage)" should be treated as current-period costs. Under this concept, if the costs associated with the actual level of spoilage or production defects are greater than the costs associated with the range of normal spoilage or defects, the difference should be charged to current-period expense. SFAS No. 151 is effective for annual periods beginning after June 15, 2005. The adoption of SFAS No. 151 did not have a material impact on the Company's results of operations and financial condition.

In December 2004, the FASB issued SFAS No. 123R, "Share Based Payment". SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R will be effective for the Company at the beginning of fiscal 2007. Although the adoption of SFAS No. 123R will have no adverse impact on our balance sheet or total cash flows, it will affect our net income and earnings per share. The actual effects of adopting SFAS No. 123R will depend on numerous factors including the amounts of share-based payments granted in the future, our stock price volatility, estimated forfeiture rates and employee stock option exercise behavior. See Note 2 for the effect on reported net income and earnings per share if we had accounted for our stock option plan using the fair value method. In March 2005, the U.S. Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107"), which expresses views of the SEC staff regarding the application of SFAS No. 123(R). Among other things, SAB 107 provides interpretive guidance related to the interaction between SFAS No. 123(R) and certain SEC rules and regulations, and provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies.

In December 2004, the FASB issued Staff Position FAS 109-1 regarding Income from Domestic Production Activities which was effective immediately. Staff Position FAS 109-1 clarifies SFAS No. 109's guidance that applies to the new deduction for qualified domestic production activities. The staff position clarifies that the deduction should be accounted for as a special deduction under SFAS No. 109. The adoption of Staff Position FAS 109-1 did not have a material impact on the Company's results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets - Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions". SFAS No. 153 requires that exchanges should be recorded and measured at the fair value of the assets exchanged, with certain exceptions. SFAS No. 153 was

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Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 2. Summary of Significant Accounting Policies, Continued

effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a significant impact on the Company's results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3". SFAS 154 requires retrospective application to prior period financial statements of a voluntary change in accounting principle and was effective in the first quarter of 2006. The adoption of SFAS 154 did not have a material effect on results of operations, financial condition or cash flows.

Impairment of Long-Lived Assets
Long-lived assets, including property, plant, and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying

amount of the asset exceeds the fair value of the asset. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

Concentrations of Risk

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

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

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

Note 3. Contracts in Process

Contracts in process at June 30, 2006 and 2005 are as follows:

	2006	
Gross contract value	$37,722,746	$31
Costs related to contracts in process, net of progress payments of $234,154 in fiscal 2006 and $97,758 in fiscal 2005	$ 8,301,077	$ 6

Included in costs relating to contracts in process at June 30, 2006 and 2005 are costs of $1,895,688 and $1,814,905, respectively, relative to contracts that may not be completed within the ensuing year. Under the units-of-delivery method, the related sale and cost of sales will not be reflected in the statement of income until the units under contract are shipped.

Note 4. Property, Plant and Equipment

A summary of the original cost of property, plant and equipment at June 30, 2006 and 2005 is as follows:

	2006	2005
Land	$ 45,000	$ 45,000
Building and improvements	3,704,503	4,065,040
Machinery and equipment	7,143,329	7,831,278
Furniture, fixtures and office equipment	243,140	321,732
	11,135,972	12,263,050
Accumulated depreciation	(8,253,520)	(9,278,213)
	$ 2,882,452	$ 2,984,837

Depreciation expense was $532,735 and $541,041, during the years ended June 30, 2006 and 2005, respectively.

Note 5. Line of credit

At June 30, 2006, 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 at the borrower's choice of (I) prime minus .75% or (II) LIBOR plus 1.80% for periods of 1, 2, or 3 months. Any borrowing under the line of credit will be collateralized by accounts receivable.

Note 6. Research and Development Costs

Research and development costs charged to cost of sales during the years ended June 30, 2006 and 2005 were approximately $121,000 and $187,000, respectively.

Note 7. Pension Expense

Under terms of a negotiated union contract, the Company is obligated to make contributions to a union-sponsored defined benefit pension plan covering eligible employees. Such contributions and expenses are based upon hours worked at a specified rate and amounted to $88,138 in fiscal 2006 and $86,876 in fiscal 2005.

The Company sponsors a 401(k) plan with employee and employer matching contributions. The employer match is 10% of the employee contribution and was $32,590 and $28,855, for fiscal years 2006 and 2005, respectively.

Note 8. Provision for Income Taxes

A summary of the components of the provision for income taxes for the years ended June 30, 2006 and 2005 is as follows:

	2006	2005
Current tax expense - federal	$ 823,564	$ 419,649
Current tax expense - state	85,351	38,666
Deferred tax (benefit) expense	(100,376)	(85,380)
	$ 808,539	$ 372,935

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 SFAS No. 109.

The combined U.S. federal and state effective income tax rates of 34.2% and 27.6%, for 2006 and 2005 respectively, differed from the statutory U.S. federal income tax rate for the following reasons:

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Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 8. Provision for Income Taxes, Continued

	2006	2005
U.S. federal statutory income tax rate	34.0%	34.0%
Increase (reduction) in rate resulting from:		
State franchise tax, net of federal income tax benefit	2.4	1.9
Foreign exportation benefit	(0.8)	(2.7)
ESOP cost versus Fair Market Value	1.0	--
Dividend on allocated ESOP shares	(1.8)	--
Qualified Production Activities	(1.0)	--
Adjustment of deferred tax accounts	--	(5.2)
Other	0.4	(0.4)
Effective tax rate	34.2%	27.6%

For the years ended June 30, 2006 and 2005 deferred income tax benefit of $(100,376) and $(85,380), respectively, result from the changes in temporary differences for each year. Adjustments were made to the Company's deferred tax assets and liabilities in fiscal 2005 based on an analysis completed in fiscal 2005. The tax effects of temporary differences that give rise to deferred tax assets and deferred tax liabilities as of June 30, 2006 and 2005 are presented as follows:

	2006	2005
Deferred tax assets:		
Accrued expenses	$142,269	$125,215
ESOP	30,328	--
Other	12,500	13,964
Total deferred tax assets	185,097	139,179
Deferred tax liabilities:		
Property, plant and equipment - principally due to differences in depreciation methods	226,653	298,057
Inventory - effect on uniform capitalization	20,128	3,182
Total deferred tax liabilities	246,781	301,239
Net deferred tax liability	$ 61,684	$162,060

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.

Note 9. 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 three domestic customers accounted for 35%, 17%, and 13% of total sales in fiscal 2006. Sales to two domestic customers accounted for 32% and 14% of total sales in fiscal 2005, respectively.

Export sales in fiscal 2006 and fiscal 2005 were approximately $3,392,000 and $4,946,000, respectively.

Note 10. Stock Rights Plan

The Company has a Shareholder Rights Plan that expires on December 31, 2009. 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 (after giving effect to the stock split described in Note 17) 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 offer or, together with all affiliates and associates thereof, being the beneficial owner of 15% or more of the Company's common stock.

Note 11. Employee Stock Ownership Plan

The Company sponsors a leveraged employee stock ownership plan (the "ESOP") that covers all nonunion employees who work 1,000 or more hours per year and are employed on June 30. Prior to July 15, 2005, the ESOP owned 230,120 shares, all of which were allocated to employees. On July 15, 2005, pursuant to a Stock Purchase Agreement dated as of such date, the Company, by selling 150,000 shares of its common stock, par value $0.33-1/3 per share, to the Espey Mfg. & Electronics Corp. Employee Stock Ownership Plan Trust, provided more shares to be allocated to employees for services rendered over the next 15 years. The ESOP paid $28.90 per share, for an aggregate purchase price of $4,335,000. The determination of the purchase price was based on a fairness opinion obtained by an independent valuation firm. The ESOP borrowed from the Corporation an amount equal to the purchase price. The loan will be repaid in fifteen (15) equal annual installments of principal and the unpaid balance will bear interest at a fixed rate of 6.25% per annum, the "prime rate" as quoted in The Wall Street Journal on the date of closing. The above ESOP information has not been adjusted for the stock split completed December 30, 2006.

The Board of Directors of the Company had approved a purchase price per share equal to a 5% discount on the average trading price of the Company's common stock on the American Stock Exchange on the date before closing, but in no event greater than the fair market value as determined by an independent valuation firm retained by the ESOP. The average trading price of the Company's common stock on the American Stock Exchange on July 14, 2005 was $30.72.

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

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

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

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Note 11. Employee Stock Ownership Plan, Continued

repaid, shares are released and allocated to active employees, based on the proportion of debt service paid in the year. The Company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the shares purchased by the ESOP are reported as Unearned ESOP Shares in the statement of financial position. As shares are released or committed-to-be-released, the Company reports compensation expense equal to the current average market price of the shares, and the shares become outstanding for earnings-per-share (EPS) computations. ESOP compensation expense was $446,238 for the year ended June 30, 2006. The ESOP shares as of June 30, 2006, after the stock split referred to in Note 17, were as follows:

Allocated Shares	446,418
Committed-to-be-released shares	--

Unreleased shares	274,167
Total shares held by the ESOP	720,585
Fair value of unreleased shares at June 30, 2006	$4,578,589

Note 12. Stock Based Compensation

During fiscal 2000, the Board of Directors and shareholders approved the 2000 Stock Option Plan (the Plan). Under the Plan, incentive and non-qualified stock options may be granted to purchase shares of common stock of the Company. Options authorized for issuance under the Plan totaled 300,000. As of June 30, 2006, the Plan was authorized to grant options to purchase 96,600 shares of the Company's common stock.

Options under the Plan have been granted with exercise prices at fair market value at the grant date and vest over a period of two years. All options must be exercised within 10 years from the date of grant and are exercisable anytime after the two-year vesting period.

Information concerning the plans incentive and non-qualified stock options is as follows:

	Option Shares	Option Price Per Share
June 30, 2004	74,000	$6.63 - 9.93
Options granted	31,000	$11.25
Options canceled	(3,000)	$8.98 - 11.25
Options exercised	(4,800)	$8.98 - 9.93
June 30, 2005	97,200	$6.63 - 11.25
Options granted	76,200	$17.36 - 17.80
Options canceled	(4,000)	$6.63 - 11.25
Options exercised	(23,200)	$6.63 - 9.93
June 30, 2006	146,200	

The table below summarizes information with respect to stock options outstanding as of June 30, 2006:

Exercise Prices	Options Outstanding	Remaining Contractual Life	Options Exercisable	Exercise Price of Exercisable Options
$ 6.63	1,400	4	1,400	$ 6.63
$ 8.98	4,600	5	4,600	$ 8.98
$ 9.93	14,200	6	14,200	$ 9.93
$ 9.25	21,400	7	21,400	$ 9.25
$11.25	28,400	8	--	--
$17.36	37,000	9	--	--
$17.80	39,200	10	--	--
Total	146,200		41,600	

Espey Mfg. & Electronics Corp.
Notes to Financial Statements

Note 12. Stock Based Compensation, Continued

The weighted average fair value of options granted under the plans during fiscal years 2006 and 2005 was $4.11 and $3.89, respectively. The assumptions used for the Black-Scholes model are as follows:

	2006	2005
Risk-free interest rate....................	4.5%	4.0%
Expected term..............................	5.5 years	5 years
Company's expected volatility..............	22.5%	20.0%
Dividend yield.............................	2.1%	3.0%

As described in note 17, a stock split in the form of a stock dividend of one share of common stock for each share of common stock issued, was paid on December 30, 2005 (all per share and share amounts have been adjusted to reflect this dividend).

Note 13. Financial Instruments/Concentration of Credit Risk

The carrying amounts of financial instruments, including cash and cash equivalents, short term investments, accounts receivable, accounts payable and accrued expenses, approximated fair value as of June 30, 2006 and 2005 because of the relatively short maturities of these instruments.

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, short-term investments and accounts receivable. The Company maintains cash and cash equivalents with various financial institutions. At times such investments may be in excess of FDIC insurance limits. As disclosed in Note 9, 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 of the Company's total trade accounts receivable balance, represented at June 30, 2006 by three customers, was 63% and by two customers at June 30, 2005 was 57%.

Although the Company's exposure to credit risk associated with nonpayment of these 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 14. Related Parties

The Company paid a law firm in which a director of the Company is a partner, a total of $19,658 and $72,979, for legal services during fiscal years ended June 30, 2006 and 2005, respectively. Included in the payment of $19,658 and $72,979 for fiscal year ended June 30, 2006 and 2005, was $9,085 and $23,750, respectively, held in trust and paid to other service providers relating to the ESOP transaction described in Note 11.

The shares of common stock owned by the ESOP Trust are voted by the Trustees in the manner directed by the ESOP Committee. The Trustees, Howard Pinsley and Peggy A. Murphy, are the Chairman of the Board, Chief Executive Officer and President of the Company and Secretary of the Company, respectfully. See Note 11 for additional information regarding the ESOP.

Note 15. Commitments and Contingencies

The Company has entered into standby letters of credit agreements with financial institutions primarily relating to the guarantee of future performance on certain contracts. Contingent liabilities on outstanding standby letters of credit agreements aggregated $246,625 at June 30, 2006. The Company does not expect to fund any of the amounts under the standby letters of credit.

Note 16. Quarterly Financial Information (Unaudited)

2006	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net Sales.................	$4,560,574	$5,056,083	$4,677,808	$6,557,105
Gross profit	880,290	947,360	1,042,265	1,672,174
Net income.............	217,744	274,260	365,057	700,955
Net income per share -				
Basic.....................	0.11	0.14	0.18	0.34
Diluted...................	0.11	0.13	0.18	0.34
2005				
Net Sales.................	$4,730,327	$4,896,741	$4,219,861	$4,981,771
Gross profit	649,142	772,387	650,890	1,308,938
Net income.............	60,585	167,032	111,987	639,316
Net income per share -				
Basic.....................	0.03	0.08	0.06	0.31
Diluted...................	0.03	0.08	0.06	0.31

Note 17. Stock Split

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

Item 8. Changes in and disagreements with accountants on accounting and financial disclosure

None

Item 8A. 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-KSB. 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.

Item 8B. Other information

None.

PART III

The information called for by "Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Registrant", "Item 10. Executive Compensation", "Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters", "Item 12. Certain Relationships and Related Transactions" 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 November 17, 2006) to be filed with the SEC pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended.

Item 13. Exhibits

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 By-laws (incorporated by reference to Exhibit 3.2 to Espey's Report on Form 10-Q for the quarter ended March 31, 2004)

4.1 Amended and Restated Rights Agreement, dated March 31, 1989, as amended February 12, 1999 and December 31, 1999, between Espey Mfg. & Electronics Corp. and Registrar and Transfer Company (incorporated by reference to Espey's Form 8-K dated December 20, 1999)

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

10.1 2000 Stock Option Plan (incorporated by reference to Espey's Definitive Proxy Statement dated December 6, 1999 for the January 4, 2000 annual meeting)

10.2 Executive Officer contract (filed herewith)

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

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

23.1 Consent of Rotenberg & Co., LLP (filed herewith)

23.2 Consent of KPMG LLP (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)

S I G N A T U R E S

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/Howard Pinsley
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Howard Pinsley
President and
Chief Executive Officer

/s/Howard Pinsley	President
---------------------------	(Chief Executive Officer)
Howard Pinsley	September 25, 2006

/s/David O'Neil --------------------------- David O'Neil	Treasurer (Principal Financial Officer) September 25, 2006
/s/Katrina Sparano --------------------------- Katrina Sparano	Assistant Treasurer (Principal Accounting Officer) September 25, 2006
/s/Barry Pinsley --------------------------- Barry Pinsley	Director September 25, 2006
/s/Seymour Saslow --------------------------- Seymour Saslow	Director September 25, 2006
/s/Michael W. Wool --------------------------- Michael W. Wool	Director September 25, 2006
/s/Paul J. Corr --------------------------- Paul J. Corr	Director September 25, 2006
/s/Alvin O. Sabo --------------------------- Alvin O. Sabo	Director September 25, 2006
/s/Carl Helmetag --------------------------- Carl Helmetag	Director September 25, 2006