

IKONICS CORP  
Form 10-Q  
May 12, 2011

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**U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

(Mark One)

☒ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Quarterly Period Ended March 31, 2011**

**or**

☐ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Transition Period From \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number 000-25727  
IKONICS CORPORATION**

(Exact name of registrant as specified in its charter)

Minnesota

41-0730027

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. employer  
identification no.)

4832 Grand Avenue  
Duluth, Minnesota

55807

(Address of principal executive offices)

(Zip code)

(218) 628-2217

Issuer's telephone number  
Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.)

Yes ☐ No ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practical date: Common Stock, \$.10 par value 1,981,607 shares outstanding as of April 25, 2011.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐  
(Do not check if a smaller  
reporting company)

Smaller reporting  
company ☐

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**IKONICS Corporation**  
QUARTERLY REPORT ON FORM 10-Q

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. Condensed Financial Statements****IKONICS CORPORATION****CONDENSED BALANCE SHEETS**

	<b>March 31 2011 (unaudited)</b>	<b>December 31 2010</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash	\$ 752,262	\$ 1,291,383
Short-term investments	2,222,538	2,217,990
Trade receivables, less allowance of \$60,000 in 2011 and 2010	1,948,761	1,883,428
Inventories	2,767,940	2,198,064
Prepaid expenses and other assets	131,874	63,965
Income taxes receivable	4,574	
Deferred income taxes	157,000	157,000
 Total current assets	 7,984,949	 7,811,830
 <b>PROPERTY, PLANT, AND EQUIPMENT, at cost:</b>		
Land and building	5,891,696	5,888,445
Machinery and equipment	2,472,354	2,455,238
Office equipment	688,476	642,100
Vehicles	234,650	234,650
	9,287,176	9,220,433
Less accumulated depreciation	4,305,988	4,207,500
	4,981,188	5,012,933
 <b>INTANGIBLE ASSETS, less accumulated amortization of \$389,597 in 2011 and \$376,983 in 2010</b>	 328,093	 317,168
	<b>\$ 13,294,230</b>	<b>\$ 13,141,931</b>
 <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 522,499	\$ 441,830
Accrued compensation	241,824	282,196
Other accrued expenses	73,255	45,868
Income taxes payable		8,090
 Total current liabilities	 837,578	 777,984
 <b>DEFERRED INCOME TAXES</b>	 171,000	 171,000
 Total liabilities	 1,008,578	 948,984

STOCKHOLDERS' EQUITY:

Preferred stock, par value \$.10 per share; authorized 250,000 shares; issued  
none

Common stock, par value \$.10 per share; authorized 4,750,000 shares; issued  
and outstanding 1,981,357 shares in 2011 and 1,973,357 shares in 2010

Additional paid-in capital

Retained earnings

Total stockholders' equity

198,136 197,336

2,317,739 2,263,176

9,769,777 9,732,435

12,285,652 12,192,947

\$ 13,294,230 \$ 13,141,931

See notes to condensed financial statements.

**Table of Contents****IKONICS CORPORATION****CONDENSED STATEMENTS OF INCOME (Unaudited)**

	<b>Three Months Ended March 31</b>	
	<b>2011</b>	<b>2010</b>
NET SALES	\$ 3,653,099	\$ 3,684,577
COST OF GOODS SOLD	2,186,256	2,200,782
GROSS PROFIT	1,466,843	1,483,795
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	1,343,641	1,200,389
RESEARCH AND DEVELOPMENT EXPENSES	99,911	160,704
INCOME FROM OPERATIONS	23,291	122,702
INTEREST INCOME	4,562	3,519
INCOME BEFORE INCOME TAXES	27,853	126,221
INCOME TAX BENEFIT	9,489	22,120
NET INCOME	\$ 37,342	\$ 148,341
EARNINGS PER COMMON SHARE:		
Basic	\$ 0.02	\$ 0.08
Diluted	\$ 0.02	\$ 0.08
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
Basic	1,976,523	1,967,057
Diluted	1,981,114	1,969,433

See notes to condensed financial statements.

**Table of Contents****IKONICS CORPORATION****CONDENSED STATEMENTS OF CASH FLOWS (Unaudited)**

	<b>Three Months Ended March 31</b>	
	<b>2011</b>	<b>2010</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 37,342	\$ 148,341
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	98,488	101,147
Amortization	12,614	13,813
Stock based compensation	6,126	6,846
Changes in working capital components:		
Trade receivables	(65,333)	(32,755)
Inventories	(569,876)	74,100
Prepaid expenses and other assets	(67,909)	(54,576)
Income taxes receivable	(4,574)	
Accounts payable	80,669	93,136
Accrued liabilities	(12,985)	(122,075)
Income taxes payable	(14,562)	(43,535)
Net cash provided by (used in) operating activities	(500,000)	184,442
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment	(66,743)	(68,408)
Proceeds from sale of vehicles		8,434
Purchase of intangibles	(23,539)	(9,880)
Purchase of short-term investments	(813,224)	(203,402)
Proceeds from maturity of short-term investments	808,676	200,000
Net cash used in investing activities	(94,830)	(73,256)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from exercise of stock options	55,709	
<b>NET INCREASE (DECREASE) IN CASH</b>	<b>(539,121)</b>	<b>111,186</b>
<b>CASH AT BEGINNING OF PERIOD</b>	<b>1,291,383</b>	<b>1,304,586</b>
<b>CASH AT END OF PERIOD</b>	<b>\$ 752,262</b>	<b>\$ 1,415,772</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b> Cash paid for income taxes, net of refunds received of \$74,156 in 2010	\$ 9,647	\$ 56,415

See notes to condensed financial statements.



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**IKONICS CORPORATION**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**

(Unaudited)

**1. Basis of Presentation**

The balance sheet of IKONICS Corporation (the Company) as of March 31, 2011, and the related statements of income and cash flows for the three months ended March 31, 2011 and 2010 have been prepared without being audited.

In the opinion of management, these statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of IKONICS Corporation as of March 31, 2011, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

**2. Short Term Investments**

The Company's \$2,223,000 of short-term investments is comprised of fully insured certificates of deposit with maturities ranging from six to twelve months and interest rates ranging from 0.3% to 1.7%.

**3. Inventories**

The major components of inventory are as follows:

	Mar 31, 2011	Dec 31, 2010
Raw materials	\$ 1,886,335	\$ 1,403,875
Work-in-progress	340,526	294,006
Finished goods	1,560,767	1,493,226
Reduction to LIFO cost	(1,019,688)	(993,043)
Total Inventory	\$ 2,767,940	\$ 2,198,064

Table of Contents**IKONICS CORPORATION****NOTES TO CONDENSED FINANCIAL STATEMENTS**

(Unaudited)

## 4. Earnings Per Common Share (EPS)

Basic EPS is calculated using net income divided by the weighted average of common shares outstanding. Diluted EPS is similar to Basic EPS except that the weighted average number of common shares outstanding is increased to include the number of additional common shares that would have been outstanding if the potential dilutive common shares, such as those shares subject to options, had been issued.

Shares used in the calculation of diluted EPS are summarized below:

	Three Months Ended	
	Mar 31, 2011	Mar 31, 2010
Weighted average common shares outstanding	1,976,523	1,967,057
Dilutive effect of stock options	4,591	2,376
Weighted average common and common equivalent shares outstanding	1,981,114	1,969,433

Options to purchase 7,250 shares of common stock with a weighted average price of \$8.22 were outstanding during the quarter ended March 31, 2011, but were excluded from the computation of common share equivalents because they were anti-dilutive. For the quarter ended March 31, 2010, options to purchase 17,500 shares of common stock with a weighted average price of \$7.65 were outstanding, but were excluded from the computation of common share equivalents because they were anti-dilutive.

## 5. Stock-based Compensation

The Company has a stock incentive plan for the issuance of up to 442,750 shares of common stock. The plan provides for granting eligible participants stock options or other stock awards, as described by the plan, at option prices ranging from 85% to 110% of fair market value at date of grant. Options granted expire up to seven years after the date of grant. Such options generally become exercisable over a one to three year period. A total of 125,573 shares of common stock are reserved for additional grants of options under the plan at March 31, 2011. The Company charged compensation cost of approximately \$6,100 and \$6,800 against income for the three months ended March 31, 2011 and 2010, respectively. As of March 31, 2011 there was approximately \$30,000 of unrecognized compensation cost related to unvested share-based compensation awards granted. That cost is expected to be recognized over the next three years.

The Company receives a tax deduction for certain stock option exercises during the period in which the options are exercised, generally for the excess of the market price at the time the stock options are exercised over the exercise price of the options, which increased the APIC pool, which is the amount that represents the pool of excess tax benefits available to absorb tax shortages. There were no excess tax benefits recognized during the three month period ending March 31, 2011 and 2010, respectively. The Company's APIC pool totaled approximately \$111,000 at March 31, 2011 and December 31, 2010, respectively.

Proceeds from the exercise of stock options were \$56,000 for the three months ended March 31, 2011. There were no options exercised during the three months ended March 31, 2010.

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(Unaudited)

Stock option activity during the three months ended March 31, 2011 was as follows:

	Shares	Weighted Average Exercise Price
Outstanding at beginning of period	40,500	\$ 6.38
Granted		
Exercised	(8,000)	6.96
Expired and forfeited		
Outstanding at March 31, 2011	32,500	6.24
Exercisable at March 31, 2011	11,583	6.94

The aggregate intrinsic value of all options outstanding and for those exercisable at March 31, 2011 was approximately \$53,000 and \$13,000, respectively.

**6. Segment Information**

The Company's reportable segments are strategic business units that offer different products and have varied customer bases. In previous years there were three reportable segments: Domestic, Export, and IKONICS Imaging. Domestic sells screen printing film, emulsions, and inkjet receptive film to distributors located in the United States and Canada. IKONICS Imaging sells photo resistant film, art supplies, glass, metal medium and related abrasive etching equipment to end user customers located in the United States and Canada. The IKONICS Imaging segment also included products and customers for etched composites, ceramics, glass and silicon wafers along with sound deadening technology to the aerospace industry, which beginning in 2011 the Company now defines as Micromachining. In addition IKONICS Imaging included products and customers related to proprietary inkjet technology used for mold texturing and referred to by the Company as Digital Texturing (DTX). Export sells primarily the same products as Domestic and the IKONICS Imaging products not related to Micromachining or DTX. Beginning in 2011, the Company no longer includes Micromachining and DTX financial information under the IKONICS Imaging segment. The financial information for Micromachining and DTX are combined into a new segment called "Other". As the Company is unable to provide comparable 2010 financial information for the newly defined segments, the Company will disclose in 2011 both the new basis and old basis of segment reporting. The accounting policies applied to determine the segment information are the same as those described in the summary of significant accounting policies included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

Management evaluates the performance of each segment based on the components of divisional income, and does not allocate assets and liabilities to segments except for accounts receivables which is allocated based on the old segmentation. Financial information with respect to the reportable segments follows:

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(Unaudited)

**For the three months ended March 31, 2011 (old segment method):**

	<b>Domestic</b>	<b>Export</b>	<b>IKONICS Imaging</b>	<b>Unalloc.</b>	<b>Total</b>
Net sales	\$ 1,331,049	\$ 1,196,213	\$ 1,125,837	\$	\$ 3,653,099
Cost of goods sold	746,008	881,726	558,522		2,186,256
Gross profit	585,041	314,487	567,315		1,466,843
Selling, general and administrative*	276,505	132,474	495,730	438,932	1,343,641
Research and development*				99,911	99,911
Income from operations	\$ 308,536	\$ 182,013	\$ 71,585	\$ (538,843)	\$ 23,291

**For the three months ended March 31, 2010 (old segment method):**

	<b>Domestic</b>	<b>Export</b>	<b>IKONICS Imaging</b>	<b>Unalloc.</b>	<b>Total</b>
Net sales	\$ 1,500,171	\$ 1,156,790	\$ 1,027,616	\$	\$ 3,684,577
Cost of goods sold	798,205	801,008	601,569		2,200,782
Gross profit	701,966	355,782	426,047		1,483,795
Selling, general and administrative*	230,855	158,659	284,661	526,214	1,200,389
Research and development*				160,704	160,704
Income from operations	\$ 471,111	\$ 197,123	\$ 141,386	\$ (686,918)	\$ 122,702

**For the three months ended March 31, 2011 (new segment method):**

	<b>Domestic</b>	<b>Export</b>	<b>IKONICS Imaging</b>	<b>Other</b>	<b>Unalloc.</b>	<b>Total</b>
Net sales	\$ 1,331,049	\$ 1,196,213	\$ 890,919	\$ 234,918	\$	\$ 3,653,099
Cost of goods sold	746,008	881,726	456,267	102,255		2,186,256
Gross profit	585,041	314,487	434,652	132,663		1,466,843
Selling general and administrative*	276,505	132,474	297,240	198,490	438,932	1,343,641
Research and development*					99,911	99,911
Income from operations	\$ 308,536	\$ 182,013	\$ 137,412	\$ (65,827)	\$ (538,843)	\$ 23,291

\* The Company does not allocate all general and administrative expenses or any research and development expenses to its operating segments for internal reporting.

Accounts receivable related to the Other segment are included in IKONICS Imaging. Accounts receivable by segment as of March 31, 2011 and December 31, 2010 were as follows:

	Mar 31, 2011	Dec 31, 2010
Domestic	\$ 832,639	\$ 874,535
Export	751,464	725,007
IKONICS Imaging	378,625	325,334
Unallocated	(13,967)	(41,448)
 Total	 \$ 1,948,761	 \$ 1,883,428

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**IKONICS CORPORATION**

**NOTES TO CONDENSED FINANCIAL STATEMENTS**

(Unaudited)

7. Income Taxes

The Company reports a liability for unrecognized tax benefits taken or expected to be taken when they are uncertain. During the first quarter of 2010, the statute of limitations for the relevant taxing authority to examine and challenge the tax position for an open year expired, resulting in decreases in income tax expense of \$27,000 for the first quarter of 2010. As of March 31, 2011 and 2010, there was no liability for unrecognized tax benefits. The Company is subject to taxation in the United States and various states. The material jurisdictions that are subject to examination by tax authorities primarily include Minnesota and the United States, for tax years 2007, 2008, 2009, and 2010.

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**IKONICS CORPORATION**

*The information presented below in Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are subject to risks and uncertainties, including those discussed under Factors that May Affect Future Results below, that could cause actual results to differ materially from those projected. Because actual results may differ, readers are cautioned not to place undue reliance on these forward-looking statements. Certain forward-looking statements are indicated by italics.*

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

The following management's discussion and analysis focuses on those factors that had a material effect on the Company's financial results of operations during the first quarter of 2011 and for the same period of 2010. It should be read in connection with the Company's condensed unaudited financial statements and notes thereto included in this Form 10-Q.

**Factors that May Affect Future Results**

*The Company's expectation that its effective tax rate will return to 35% to 36% of pretax income for the remainder of 2011 compared to the tax benefit recorded in the first three months of 2011* The effective tax rate for the final nine months of 2011 may be affected by changes in federal and state tax law, unanticipated changes in the Company's financial position or the Company's operating activities and/or management decisions could increase or decrease its effective tax rate.

*The Company's belief that the quality of its trade receivables is high and that strong internal controls are in place to maintain proper collections* This belief may be impacted by domestic economic conditions, by economic, political, regulatory or social conditions in foreign markets, or by the failure of the Company to properly implement or maintain internal controls.

*The Company's expectation that it will obtain a new line of credit similar to its current line of credit when the current line of credit expires on October 30, 2011* This expectation may be impacted by factors such as changes in credit markets, the interest rate environment, general economic conditions, the Company's financial results and condition, and the Company's anticipated need for capital to fund business operations and capital expenditures.

*The belief that the Company's current financial resources, cash generated from operations and the Company's capacity for debt and/or equity financing will be sufficient to fund current and anticipated business operations and capital expenditures. The belief that the Company's low debt levels and available line of credit make it unlikely that a decrease in product demand would impair the Company's ability to fund operations* Changes in anticipated operating results, credit availability, equity market conditions or the Company's debt levels may further enhance or inhibit the Company's ability to maintain or raise appropriate levels of cash.

*The Company's expectations as to the level and use of planned capital expenditures and that capital expenditures will be funded with cash on hand and cash generated from operating activities* This expectation may be affected by changes in the Company's anticipated capital expenditure requirements resulting from unforeseen required maintenance, repairs, or capital asset additions. The funding of planned or unforeseen expenditures may also be affected by changes in anticipated operating results resulting from decreased sales, lack of acceptance of new products or increased operating expenses or by other unexpected events affecting the Company's financial position.

*The Company's belief that its vulnerability to foreign currency fluctuations and general economic conditions in foreign countries is not significant* This belief may be impacted by economic, political and social conditions in foreign markets, changes in regulatory and competitive conditions, a change in

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the amount or geographic focus of the Company's international sales, or changes in purchase or sales terms. *The Company's expectation that research and development spending will grow and return to historic levels* These plans and expectations may be impacted by the Company's ability to identify, hire and retain qualified personnel, unexpected changes to resource requirements for other areas of the Company's business and the overall performance of the Company.

*The Company's beliefs as to the future performance of its new technologies or particular segments* Actual performance may be impacted by general market conditions or conditions in particular industries in which the Company's products are used (including the aerospace and automotive industries), changes to the competitive landscape in the industries in which the Company competes (including pricing pressures from existing or future competitors), lack of acceptance of new products or technologies or increases to raw materials costs used to produce the Company's products.

*The Company's efforts to grow its international business* These efforts may be impacted by economic, political and social conditions in current and anticipated foreign markets, regulatory conditions in such markets, unanticipated changes in expenses or sales, changes in competitive conditions or other barriers to entry or expansion.

*The Company's belief as to future activities that may be undertaken to expand the Company's business* Actual activities undertaken may be impacted by general market conditions, competitive conditions in the industries in which the Company sells products, unanticipated changes in the Company's financial position, lack of acceptance of new products or the inability to identify attractive acquisition targets or other business opportunities.

## **Critical Accounting Estimates**

The Company prepares its financial statements in conformity with accounting principles generally accepted in the United States of America. Therefore, the Company is required to make certain estimates, judgments and assumptions that the Company believes are reasonable based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. The accounting estimates, which IKONICS believes are the most critical to aid in fully understanding and evaluating its reported financial results, include the following:

*Trade Receivables.* The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history and the customer's current credit worthiness, as determined by review of the current credit information. The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses based upon historical experience and any specific customer collection issues that have been identified. While such credit losses have historically been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same collection history that has occurred in the past. The general payment terms are net 30-45 days for domestic customers and net 30-90 days for foreign customers. A small percentage of the trade receivables balance is denominated in a foreign currency with no concentration in any given country. At the end of each reporting period, the Company analyzes the receivable balance for customers paying in a foreign currency. These balances are adjusted to each quarter or year spot rate in accordance with guidance related to foreign currency matters.

*Inventories.* Inventories are valued at the lower of cost or market value using the last in, first out (LIFO) method. The Company monitors its inventory for obsolescence and records reductions in cost when required.

*Income Taxes.* At March 31, 2011, the Company had net current deferred tax assets of \$157,000 and net noncurrent deferred tax liabilities of \$171,000. The deferred tax assets and liabilities result primarily from temporary differences in property and equipment, accrued expenses, and inventory reserves. In connection with the recording of a \$919,000 impairment charge in 2009 related to an investment in a non-marketable equity security, the



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Company has recorded a deferred tax asset and corresponding full valuation allowance in the amount of \$323,000 as of March 31, 2011 and December 31, 2010 as it is more likely that this asset will not be realized. The deferred tax asset related to the capital loss can be carried back three years and carried forward five years and must be offset by a capital gain. The Company has determined that is more likely than not that the remaining deferred tax assets will be realized and that an additional valuation allowance for such assets is not currently required. The Company accounts for its uncertain tax positions under the provision of FASB ASC 740, Income Taxes. At March 31, 2011 the Company had no reserves for uncertain tax positions.

**Revenue Recognition.** The Company recognizes revenue on sales of products when title passes which can occur at the time of shipment or when the goods arrive at the customer location depending on the agreement with the customer. The Company sells its products to both distributors and end-users. Sales to distributors and end-users are recorded based upon the criteria governed by the sales, delivery, and payment terms stated on the invoices from the Company to the purchaser. In addition to transfer of title / risk of loss, all revenue is recorded in accordance with the criteria outlined within the provisions regarding revenue recognition including:

- (a) persuasive evidence of an arrangement (principally in the form of customer sales orders and the Company's sales invoices)
- (b) delivery and performance (evidenced by proof of delivery, e.g. the shipment of film and substrates with bill of lading used for proof of delivery for FOB shipping point terms, and the carrier booking confirmation report used for FOB destination terms). Once the finished product is shipped and physically delivered under the terms of the invoice and sales order, the Company has no additional performance or service obligations to complete
- (c) a fixed and determinable sales price (the Company's pricing is established and is not based on variable terms, as evidenced in either the Company's invoices or the limited number of distribution agreements; the Company rarely grants extended payment terms and has no history of concessions)
- (d) a reasonable likelihood of payment (the Company's terms are standard, and the Company does not have a substantial history of customer defaults or non-payment)

Sales are reported on a net basis by deducting credits, estimated normal returns and discounts. The Company's return policy does not vary by geography. The Company is not under a warranty obligation and the customer has no rotation or price protection rights. Freight billed to customers is included in sales. Shipping costs are included in cost of goods sold.

**Results of Operations*****Quarter Ended March 31, 2011 Compared to Quarter Ended March 31, 2010***

**Net Sales.** The Company realized a 0.9% sales decrease during the first quarter of 2011 with sales of \$3.7 million for the comparable periods. Lower film sales resulted in Domestic sales being down 11.3% in the first quarter of 2011. First quarter Domestic sales in 2010 benefitted from a large private label sales which did not occur in 2011. Partially offsetting the Domestic sales decrease were sales into the Micromachining and DTX markets which grew from \$134,000 in the first quarter of 2010 to \$235,000 in the first quarter of 2011. Export sales were 3.4% higher during the first quarter of 2011 due stronger sales in both Asia and Europe partially offset by weaker Latin American sales. IKONICS Imaging sales into the awards and recognition markets were flat for the first quarter of 2011 when compared to the same period last year.

**Gross Profit.** Gross profit was \$1.5 million, or 40.2% of sales, in first quarter of 2011 compared to \$1.5 million, or 40.3% of sales, for the same period in 2010. The decrease in higher margin Domestic film sales resulted in a decrease in the Domestic gross margin in the first quarter from 46.8% in 2010 to 44.0% in 2011. Raw

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materials price increases have also unfavorably affected 2011 first quarter margins. Gross margins were favorably impacted by the increase in the higher margin sales related to Micromachining and DTX.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses were \$1.3 million, or 36.8% of sales, in the first quarter of 2011 compared to \$1.2 million, or 32.6% of sales, for the same period in 2010. The increase in selling, general and administrative expenses reflects higher personnel and consulting costs related to supporting the Company's Micromachining and DTX initiatives. Part of the higher personnel expenses are related to resources that were previously assigned to research and development, but have been reassigned to focus exclusively on Micromachining and DTX.

*Research and Development Expenses.* Research and development expenses during the first quarter of 2011 were \$100,000, or 2.8% of sales, versus \$161,000, or 4.4% of sales, for the same period in 2010. The decrease is due to lower staffing levels due to the reassignment of certain personnel to the Company's Micromachining and DTX initiatives. Additionally, legal and patent related expenses were lower in the first quarter of 2011 along with research related production trials.

*Interest Income.* The Company earned \$4,600 of interest income in the first quarter of 2011 compared to \$3,500 of interest income in the first quarter of 2010. The interest earned in first quarter of 2011 is related to interest received from the Company's short-term investments, which consisted of \$2,223,000 of fully insured certificates of deposit with maturities ranging from six to twelve months as of the end of first quarter of 2011.

*Income Taxes.* For the first quarter of 2011, the Company realized an income tax benefit of \$9,000 compared to income tax benefit of \$22,000 for the same quarter in 2010. During the first quarter of 2011 the Company recorded an out-of-period tax benefit adjustment of \$9,000 relating to December 31, 2010 estimate for tax. The Company also recorded a \$9,000 tax benefit related to the exercise of stock options. The 2010 first quarter benefits primarily relate to derecognizing a liability for unrecognized tax benefits relating to a tax year where the statute of limitations expired during the first quarter. A \$27,000 liability was derecognized in the first quarter of 2010. During the first quarter of 2010, the Company also recorded an out-of-period tax benefit adjustment of \$15,000 relating to December 31, 2009 estimates for tax credits as well as the receipt of interest of approximately \$13,000 related to Minnesota state income tax returns. The Company expects that for the remainder of 2011, the Company will record the provision for income taxes at an effective tax rate of 35% to 36%, as it recognizes benefits from the domestic manufacturing deduction, research and development credits, and state income taxes.

**Liquidity and Capital Resources**

The Company has financed its operations principally with funds generated from operations. These funds have been sufficient to cover the Company's normal operating expenditures, annual capital requirements, and research and development expenditures.

Cash and cash equivalents were \$752,000 and \$1,416,000 at March 31, 2011 and 2010, respectively. The Company used \$500,000 in cash for operating activities during the three months ended March 31, 2011, compared to generating \$184,000 of cash from operating activities during the same period in 2010. Cash provided by or used by operating activities is primarily the result of net income adjusted for non-cash depreciation, amortization, and certain changes in working capital components discussed in the following paragraph.

During the first three months of 2011, inventories increased by \$570,000 due to increased raw materials purchases. The higher raw material purchases were due to the timing of a large restocking orders, an increase in order quantities to take advantage of volume discounts and new raw materials necessary to support the manufacture and sale of the Company's new products. Trade receivables increased by \$65,000. The increase in receivables is related to the timing of collections. The Company believes that the quality of its receivables is high and that strong internal controls are in place to maintain proper collections. Deposits, prepaid expenses and other assets increased \$68,000, reflecting insurance premiums paid in advance in the first quarter of 2011. Accounts payable increased \$81,000 due to of the timing of payments to and purchases from vendors. Accrued expenses decreased \$12,000,

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reflecting the timing of compensation payments. Income taxes payable decreased \$15,000 and income taxes receivables increased \$5,000 due to the payment of 2010 taxes.

During the first quarter of 2011, investing activities used \$95,000. The Company's purchases of property and equipment for the quarter were \$67,000, mainly for hardware upgrades to the Company's computer network and equipment purchases. Also during the first quarter of 2011, the Company incurred \$24,000 in patent application costs that the Company records as an asset and amortizes upon successful completion of the application process. The Company invested \$813,000 in fully insured certificates of deposits with four certificates of deposit totaling \$809,000 maturing during the first three months of 2011.

During the first quarter of 2010, investing activities used \$73,000. Purchases of property and equipment were \$68,000, mainly for two vehicles and equipment purchases. The Company received \$8,000 from vehicle sales. Also during the first quarter of 2010, the Company incurred \$10,000 in patent application costs that the Company records as an asset and amortizes upon successful completion of the application process. The Company invested \$203,000 in fully insured certificates of deposits with one \$200,000 certificate of deposit maturing during the first three months of 2010.

During the first three months of 2011 the Company received \$56,000 from financing activities as the Company received \$56,000 from the issuance of 8,000 shares of common stock from the exercise of stock options.

A bank line of credit exists providing for borrowings of up to \$1,250,000. The line of credit term runs from October 31, 2010 to October 30, 2011. The Company expects to obtain a similar line of credit when the current line of credit expires. The line of credit is collateralized by trade receivables and inventories and bears interest at 2.5 percentage points over the 30-day LIBOR rate. The Company did not utilize this line of credit during the first three months of 2011 or 2010 and there were no borrowings outstanding as of March 31, 2011 and 2010. There are no financial covenants related to the line of credit.

The Company believes that current financial resources, its line of credit, cash generated from operations and the Company's capacity for debt and/or equity financing will be sufficient to fund current and anticipated business operations. The Company also believes that its low debt levels and available line of credit make it unlikely that a decrease in demand for the Company's products would impair the Company's ability to fund operations.

### **Capital Expenditures**

Through the first three months of 2011, the Company had \$67,000 in capital expenditures. Capital expenditures during the first three months were mainly for network upgrades and equipment. The Company expects capital expenditures in 2011 of approximately \$600,000. Plans for capital expenditures include two mandatory elevator and manufacturing equipment upgrades, development equipment to modernize the capabilities and processes of IKONICS laboratory, research and development to improve measurement and quality control processes and a vehicle. These commitments are expected to be funded with cash generated from operating activities.

### **International Activity**

The Company markets its products to numerous countries in North America, Europe, Latin America, Asia and other parts of the world. Foreign sales were approximately 33% of total sales during the first three months of 2011 compared to 31% of sales in the first quarter of 2010. Higher sales volumes in Europe and Asia positively impacted 2011 first quarter sales volumes. Fluctuations of certain foreign currencies have not significantly impacted the Company's operations because the Company's foreign sales are not concentrated in any one region of the world. The Company believes its vulnerability to uncertainties due to foreign currency fluctuations and general economic conditions in foreign countries is not significant.

The Company's foreign transactions are primarily negotiated, invoiced and paid in U.S. dollars, while a portion is transacted in Euros. IKONICS has not implemented an economic hedging strategy to reduce the risk of

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foreign currency translation exposures, which management does not believe to be significant based on the scope and geographic diversity of the Company's foreign operations as of March 31, 2011. Furthermore, the impact of foreign exchange on the Company's balance sheet and operating results was not material in either 2011 or 2010.

**Future Outlook**

IKONICS has spent on average over 4% of its sales dollars for the past few years in research and development; in 2011 this dropped to 3%. The 2011 first quarter reduction is due to the Company moving to commercialize its new technologies (Micro Machining and Industrial Inkjet Solutions). Two chemists who were intimately involved in the development of these technologies have been made their Product Managers. This reassignment puts the Company's technical people, with their broad product knowledge, directly in contact with industrial customers, who demand technical sales and support. As new research projects are identified, the Company anticipates that its Research and Development staff will grow to meet these needs and spending will return to historic levels.

The new technologies of Micro Machining and Industrial Inkjet (DTX) are both growing rapidly. For the first quarter of 2011 their combined sales were 74% percent above the first quarter of 2010, and the Company anticipates further strong growth. Micro Machining's aviation sound deadening technology has shown growth with several new customers interested in adopting the Company's technology, and the Company believes there are new opportunities for the machining of composite materials for the aerospace industry. The Company's machining of electronic wafers is also showing growth and increased profitability. The Company believes Micro Machining offers a unique value proposition, which the industry is just beginning to recognize.

DTX is a proprietary system for putting textures into steel molds for the plastic injection mold making; the primary end customer is automotive. The Company sells inkjet fluid and custom made substrates for use by printers supplied by the Company and its strategic partners, Colour Scanner Technology GMBH and the Trans Tech division of Illinois Tool Works Inc. IKONICS was awarded a European patent on its DTX technology in 2010 and has a patent pending in North America and Japan. The first DTX printer was sold in 2010 to a domestic customer, and it is generating consumable sales. Several potential customers, world-wide, have evidenced interest in this technology, and the Company anticipates sales once its strategic partners have printers available. The Company's strategic partners have been reluctant to manufacture these specialized printers until market demand became evident; the Company believes it is now evident and printers are in production.

In 2010 the Company developed and applied for a patent on its I-HE photo resist film for the etching of electronic wafers and developed I-XE low silicone photo resist film for the aerospace industry. Both films have been well received and have begun to generate profitable sales which the Company believes will continue in 2011.

Domestically, the Company has combined its Chromaline Screen Print Product and its Ikonics Imaging units under one leadership. These have been profitable mature markets and require aggressive strategies to grow market share. Although there will be challenges, the Company believes these businesses will continue to grow and prosper.

In addition to its traditional emphasis on domestic markets, the Company will continue efforts to grow its business internationally by attempting to develop new markets and expanding market share where it has already established a presence.

We believe that the Company's traditional businesses will show steady growth worldwide and that its new businesses will display accelerated growth.

Other future activities undertaken to expand the Company's business may include acquisitions, building improvements, equipment additions, new product development and marketing opportunities.

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**Recent Accounting Pronouncements**

The Company does not expect that the adoption of any recent accounting pronouncements will have a material impact on its financial statements.

**Off Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements.

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

Not applicable

**ITEM 4. Controls and Procedures**

As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of the Company's disclosure control and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the

Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

There was no change in the Company's internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and Rule 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

**ITEM 1. Legal Proceedings**

None

**ITEM 1A. Risk Factors**

Not applicable

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable

**ITEM 3. Defaults upon Senior Securities**

Not applicable

**ITEM 4. [Removed and Reserved]**

**ITEM 5. Other Information**

None

**ITEM 6. Exhibits**

The following exhibits are filed as part of this Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2011:

Exhibit	Description
3.1	Restated Articles of Incorporation of Company, as amended. <sup>1</sup>
3.2	By-Laws of the Company, as amended. <sup>2</sup>
31.1	Rule 13a-14(a)/15d-14(a) Certifications of CEO
31.2	Rule 13a-14(a)/15d-14(a) Certifications of CFO
32	Section 1350 Certifications

Copies of Exhibits will be furnished upon request and payment of the Company's reasonable expenses in furnishing the Exhibits.

<sup>1</sup> Incorporated by reference to the like numbered Exhibit to the Company's Registration Statement on Form 10-SB (File No. 000-25727).

<sup>2</sup> Incorporated by reference to the like numbered Exhibit to the Company's Current Report on Form 8-K filed with the Commission on February 22, 2007 (File No. 000-25727).

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IKONICS CORPORATION

**SIGNATURES**

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

IKONICS CORPORATION

DATE: May 12, 2011

By: /s/ Jon Gerlach  
Jon Gerlach,  
Chief Financial Officer, and  
Vice President of Finance

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**INDEX TO EXHIBITS**

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32	Section 1350 Certifications.	Filed Electronically