

2011 ANNUAL REPORT



CONTENTS

| | |
|--|------------|
| Letter to Shareholders | 1 |
| Management's Discussion and Analysis of Financial Condition and Results of Operations | 2 |
| Critical Accounting Estimates | 2 |
| Results of Operations | 3 |
| Market for Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities..... | 5 |
| Management's Report | 5 |
| Management's Annual Report on Internal Control Over Financial Reporting | 6 |
| Report of Independent Registered Public Accounting Firm | 6 |
| Balance Sheets | 7 |
| Statements of Income | 8 |
| Statements of Stockholders' Equity and Comprehensive Income..... | 8 |
| Statements of Cash Flows..... | 9 |
| Notes to Financial Statements | 10 |
| Board of Directors/Corporate Officers | 16 |
| IKONICS Five-Year History | Back Cover |



WILLIAM C. ULLAND

CORPORATE PROFILE

| | |
|--|--------------|
| 2011 Net Sales | \$16,780,262 |
| Earnings per common share (diluted)..... | \$0.35 |
| Company founded | 1952 |
| Employees | 72 |
| NASDAQ Symbol | IKNX |

LETTER TO SHAREHOLDERS

IKONICS experienced record sales for 2011 of \$16,780,000, a 2% increase from 2010. Due to competitive pressures in our screen printing business, we were unable to pass on all of the increasing costs of our petrochemical-based raw materials. Consequently, net income declined by 37%, to \$698,000, or \$0.35 per share. Developing and launching our new businesses also contributed to increased costs, but I believe these investments were wise, and we are beginning to see a return on them.

In 2006, we embarked on a mission to grow and diversify our business when we recognized that our traditional markets, though quite profitable, were mature. We evaluated our existing technology platforms and considered improvements or additions we could make to allow us to penetrate alternative, attractive markets.

After considerable research, and some trial and error, we moved to servicing industrial markets, including mold texturing, and the machining of silicon wafers and composite materials. We are convinced these markets represent large opportunities for Ikonics and that we have unique expertise and knowledge with which to serve them.

To our existing technology platforms of ultraviolet (UV) chemistry, film coating and construction, and technical sandblasting, we added industrial inkjet printing. To offer customers a compelling value proposition, we needed to elevate all of these technology platforms to produce products and services that exceeded those currently in the market. I believe that, in spite of a deep recession and major technological hurdles in chemistry, film construction and inkjet printer development, we have met those goals. I believe we will begin to see positive progress in 2012.

Micro-Machining Solutions is our business unit that machines electronic wafers and composite materials using precision abrasive etching. This business grew substantially in 2011 and became profitable. One of our market segments is composites where we offer substantially superior performance in important applications. Our process is presently being used on Boeing®, Airbus®, and Gulfstream® aircraft and is being tested by other major aerospace companies for use in their manufacturing processes. The aerospace industry has a very long sales cycle and, in some cases, suppliers are compelled to wait for a new design or process to be specified. Once specified, however, the sales life of a product can also be very long. Our offering is hitting the market as the aerospace industry recovers from the recession and the use of composites in aerospace manufacturing continues to grow.

Digital Texturing (DTX) is our patented technology for placing textures or patterns in the steel molds used by plastic-injection molding companies. DTX offers lower cost and better quality than competing traditional technologies, many of which are decades old. We recently introduced ExactFlat® software to further enhance the advantages of DTX. Although our primary focus for DTX is the automotive industry, there are many other applications of textured surfaces, representing a long-term opportunity for IKONICS. Our chemists and engineers have done a remarkable job of developing consumables (inks and transfer films) that will be used by the DTX inkjet printers sold by our strategic partners. The market had been waiting for our second generation, high resolution printer, which was delivered to a customer in North America in January 2012 and is currently in use. Additional DTX printer sales by our strategic partners are pending.

Our traditional businesses of manufacturing and supplying photochemical films and emulsions to the worldwide screen printing market and sand blast photoresist films to the awards and recognition industry have funded these new initiatives. To return these enterprises to their former level of profitability we are introducing new products, lowering fixed costs, and evaluating new distribution models. I believe an improvement in their profitability will coincide with the continued strong performance of Micro-Machining and the commercial launch of DTX.

WILLIAM C. ULLAND

Chairman, President & CEO

March 20, 2012

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following management discussion and analysis focuses on those factors that had a material effect on the Company's financial results of operations and financial condition during 2011 and 2010 and should be read in connection with the Company's audited financial statements and notes thereto for the years ended December 31, 2011 and 2010, included herein.

FACTORS THAT MAY AFFECT FUTURE RESULTS

Certain statements made in this Annual Report, including those summarized below, are forward-looking statements within the meaning of the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended, that involve risks and uncertainties, and actual results may differ. Factors that could cause actual results to differ include those identified below.

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 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 the amount or geographic focus of the Company's international sales, or changes in purchase or sales terms.

The Company's plans to continue to invest in research and development efforts, expedite internal product development and invest in technological alliances, as well as the expected focus and results of such investments – These plans and expectations may be impacted by general market conditions, unanticipated changes in expenses or sales, delays in the development of new products, technological advances, the ability to find suitable and willing technology partners or other changes in competitive or market conditions.

The Company's belief as to future sources of sales growth and profitability, including from photo resist film, export markets and other products the Company sells – The sources of future increases to the Company's sales and profitability, and the Company's ability to increase sales or profitability at all, may be impacted by lack of market acceptance for the Company's products, adverse changes to the global economy and consumer confidence, the adequacy of the Company's intellectual property protections, the Company's ability to customize its products for new

markets, the Company's ability to maintain the quality of its receivables while adding customers in new markets and the Company's ability to maintain its reputation for quality products.

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:

Accounts Receivable – 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 accounts receivable balance are 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 end spot rate in accordance with FASB ASC 830, Foreign Currency Matters.

Inventory – 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 from cost when required.

Income Taxes – At December 31, 2011, the Company had net current deferred tax assets of \$144,000 and net noncurrent deferred tax liabilities of \$338,000. 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 an impairment charge that occurred prior to 2010 as described below, the Company has recorded a deferred tax asset and corresponding full valuation allowance in the amount of \$323,000 as it is more likely that this asset will not be realized. The fully reserved \$323,000 deferred tax asset related to the capital loss can be carried back two years and carried forward four 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 December 31, 2011 and 2010 the Company had no reserves for uncertain tax positions. The Company had recorded a liability of \$27,000 related to an uncertain tax position which was eliminated during 2010.

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 SAB 104 and FASB ASC 605 Revenue Recognition:

- 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 customer has no rotation or price protection rights and the Company is not under a warranty obligation except for a minimal obligation related to six months of service on the DTX printer sold in 2010. Freight billed to customers is included in sales. Shipping costs are included in cost of goods sold.

RESULTS OF OPERATIONS

YEAR ENDED DECEMBER 31, 2011 COMPARED TO YEAR ENDED DECEMBER 31, 2010

Sales – The Company's net sales increased 1.6% in 2011 to a record \$16.8 million compared to net sales of \$16.5 million in 2010. Stronger sales in Asia and Latin America drove a 2.5% Export sales increase for 2011. These increases were partially offset by weaker European sales. IKONICS Imaging realized a 3.8% sales increase over 2010 due to increased film sales. In 2011, the Company determined that Micro-Machining and DTX financial information would not be included under the IKONICS Imaging segment. See Note 5 in the notes to the financial statements included in this Annual Report for a more detailed discussion on this transition. DTX and Micro-Machining sales were down 3.2% compared to last year. Sales in 2010 were favorably impacted by a DTX printer sale while no DTX printers were sold in 2011 because the Company's printer suppliers were experiencing manufacturing difficulties with a second generation printer. Strong Micro-Machining sales partially offset the DTX sales shortfall. Domestic Chromaline sales were similar to last year as increased emulsion sales were offset by lower film sales.

Gross Profit – Gross profit in 2011 was \$6.7 million, or 40.0% of sales, compared to \$6.8 million, or 41.1% of sales in 2010. Domestic and Export gross profit percentage decreased by 4.7% and 4.3%, respectively, during 2011 compared to 2010. Raw material price increases along with a decrease in higher margin film sales have unfavorably affected the gross profit percentage for both Export and Domestic. Higher margin DTX and Micro-Machining sales along with an increase in higher margin IKONICS Imaging film sales partially offset the Export and Domestic gross margin decreases.

Selling, General and Administrative Expenses – Selling, general and administrative expenses were \$5.2 million, or 30.8% of sales, in 2011 compared to \$4.6 million, or 27.7% of sales in 2010. The increase in selling, general and administrative expenses reflects higher personnel, promotion and consulting costs related to supporting the Company's Micro-Machining and DTX initiatives along with increased sales efforts in awards and recognition market. Approximately \$170,000 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 Micro-Machining and DTX.

Research and Development Expenses – Research and development expenses in 2011 were \$512,000, or 3.1% of sales, versus \$696,000, or 4.2% of sales, in 2010. The decrease is due to lower staffing levels due to the reassignment of certain personnel to the Company's Micro-Machining and DTX initiatives. Additionally, legal and patent related expenses were lower in 2011 along with research related production trials.

Interest Income – The Company earned \$17,300 of interest income in 2011 compared to \$19,700 in 2010. The interest earned in 2011 and 2010 is related to interest received from the Company's short-term investments, which consist of fully insured certificates of deposit with remaining maturities ranging from 1 to 12 months.

Income Taxes – During 2011, the Company realized income tax expense of \$345,000, or an effective rate of 33.1%, compared to income tax expense of \$440,000, or an effective rate of 28.3% in 2010. The income tax provision for 2011 and 2010 differs from the expected tax expense due to the benefits of the domestic manufacturing deduction and federal and state credits for research and development. Additionally, the effective tax rate in 2010 was impacted by derecognizing a \$27,000 liability for unrecognized tax benefits relating to a tax year where the statute of limitations expired during the year. During 2010, the Company also recorded an out-of-period tax benefit adjustment of \$15,000 relating to prior year tax credits as well as the receipt of interest of approximately \$13,000 related to Minnesota state income tax returns.

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 was \$1,867,000 and \$1,291,000 at December 31, 2011 and 2010, respectively. In addition to its cash, the Company also held \$1,835,000 of short term investments as of December 31, 2011 and \$2,218,000 of short-term investments as of December 31, 2010. The Company generated \$794,000 in cash from operating activities during 2011, compared to generating \$1,601,000 of cash from operating activities in 2010. Cash provided by operating activities is primarily the result of the net income adjusted for non cash depreciation and amortization, deferred taxes, and certain changes in working capital components discussed in the following paragraph.

During 2011, trade receivables increased by \$298,000. The increase in receivables was driven by increased Export sales which have longer payment terms and slightly slower collections than Domestic sales. Inventory levels increased \$264,000 due to higher levels of raw materials. The raw materials increase is related to the timing of the delivery of large raw material shipments at year end and higher raw material

costs. The Company also requires increased levels of raw materials to support new products. The \$19,000 increase in prepaid expenses and other assets is related to the timing of insurance payments for 2012. Accounts payable increased \$108,000 due to the timing of payments to and purchases from vendors while accrued liabilities decreased \$39,000 due to the timing of the Company's payroll. Income taxes payable decreased \$7,000 and the Company's income tax receivable increased \$59,000 due to timing of estimated 2011 tax payments compared to the calculated 2011 tax liability.

During 2011, investing activities used \$289,000. The Company's purchases of property and equipment for the year were \$622,000. These purchases were mainly for equipment to upgrade the capabilities of the Company's DTX and Micro-Machining operations, equipment to improve product quality and capacity, mandatory elevator improvements, one vehicle and hardware to upgrade the Company's computer network. Also during 2011, the Company incurred \$60,000 in patent application costs that the Company records as an asset and amortizes upon successful completion of the application process. The Company also invested \$2,446,000 in twelve fully insured certificates of deposits during 2011. Fourteen certificates of deposit totaling \$2,829,000 matured in 2011.

During 2010, investing activities used \$1,637,000. The Company invested \$2,621,000 in fully insured certificates of deposits with six \$200,000 certificates of deposit maturing during 2010. Purchases of property and equipment totaled \$189,000. These capital expenditures were mainly for production equipment and three vehicles for sales persons. The Company received \$22,000 from vehicle and equipment sales during 2010. Also during 2010, the Company incurred \$54,000 in patent application costs.

During 2011, the Company received \$71,000 from financing activities as the Company received \$73,000 from the issuance of 11,500 shares of common stock from the exercise of stock options. The Company used \$2,100 in financing activities during 2011 to repurchase 270 shares of its own stock. During 2010, the Company received \$23,000 from financing activities. The Company received \$37,000 from the issuance of 8,500 shares of common stock from the exercise of stock options and the Company repurchased 2,200 shares of its own stock for \$15,000.

A bank line of credit exists providing for borrowings of up to \$1,250,000. The line of credit term runs from October 31, 2011 to October 30, 2012. 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 inventory and bears interest at 2.5 percentage points over the 30 day LIBOR rate. The Company did not utilize this line of credit during 2011 and 2010 and there were no borrowings outstanding as of December 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

In 2011, the Company had \$622,000 in capital expenditures. Capital expenditures in 2011 were for equipment to upgrade the capabilities of the Company's DTX and Micro-Machining operations, equipment to improve product quality and capacity, mandatory elevator improvements, one vehicle and hardware to upgrade the Company's computer network. In addition, the Company transferred \$227,000 of

DTX equipment from inventory to equipment during the year. The DTX equipment was purchased for inventory in 2010. Instead of offering the DTX equipment for sale, the Company decided it would be necessary to keep the equipment for product testing and customer demonstrations.

In 2010, the Company had \$189,000 in capital expenditures. These capital expenditures were mainly for production equipment and three vehicles for sales persons.

The Company expects capital expenditures in 2012 of approximately \$550,000 and includes expenditures for manufacturing equipment upgrades and capacity increases and vehicles for sales personnel. It also includes \$150,000 in expenditures to complete the mandatory elevator upgrades and an equipment upgrade project which were both started in 2011. These commitments are expected to be funded with cash generated from operating activities.

INTERNATIONAL ACTIVITY

The Company markets its products in numerous countries in all regions of the world, including North America, Europe, Latin America, and Asia. The Company's 2011 foreign sales of \$5,556,000 were approximately 33.1% of total sales, compared to the 2010 foreign sales of \$5,421,000, which were 32.8% of total sales. The increase in foreign sales in 2011 was primarily due to growth of 3.3% Asia and Latin America while 2011 European sales were down 7.5% compared to last year. The Company is exposed to the risk of changes in social, political, and economic conditions inherent in foreign operations, and the Company's results of operations are affected by fluctuations in foreign currency exchange rates. Fluctuations in 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 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 December 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 3%- 4% of its sales dollars for the past few years in research and development and has made capital expenditures related to its DTX and Micro-Machining programs. The Company plans to maintain its efforts in this area and expedite internal product development as well as form technological alliances with outside experts to commercialize new product opportunities.

In 2011, the Company made substantial progress on its new Micro-Machining business initiatives. During the year, Micro-Machining sales grew, became profitable and manufacturing capacity was increased. Micro-Machining is also in the process of being qualified for production by three major aerospace companies. Although the sales cycle with these customers is long, once specified as a process or component, the life of the business can be very long term. The recognition by the industry of the Company's unique ability to machine composite materials is coinciding with increasing demand for composite materials by the aerospace industry.

In addition, the Company made substantial progress in 2011 on its DTX business initiatives. A DTX first generation printer was sold to a customer beta site in the fourth quarter of 2010; it is performing to expectations and generating sales for the

Company of related consumables. In January 2012, the Company placed a second generation DTX printer with a North America mold maker and has been informed by its DTX printer manufacturing partner, Colour Scanner Technology GMBH, of other pending orders. In February of 2012, the Company announced a partnership and distribution agreement with Tri-D Technology to provide ExacFlat software for placing textures on 3D molds. The Company believes, that coupled with DTX, this technology provides the mold maker with the fastest, most accurate and cost effective way to apply decorative features to 3D mold. The Company was also awarded a European patent on its DTX technology in 2010 and a U. S. patent in 2012. Additional U. S. and European patent applications, as well as a Japanese patent application, are currently being examined by the respective patent offices.

In 2011, the Company's traditional domestic screen print stencil business was flat. The Company anticipates growth in this area in 2012 with an improving economy and new sales efforts. Sales to the awards and recognition market of the Company's sandblast resist films rebounded in 2011 with the improving economy, and the Company expects that trend to continue in 2012.

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

OFF-BALANCE SHEET ARRANGEMENTS

The Company has no off-balance sheet arrangements.

RECENT ACCOUNTING PRONOUNCEMENTS

None

MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's Common Stock is traded on the Nasdaq Capital Market under the symbol IKNX. The following table sets forth, for the fiscal quarters indicated, the high and low sales prices for the Company's Common Stock as reported on the Nasdaq Capital Market for the periods indicated.

| Fiscal Year Ended December 31, 2011: | High | Low |
|---|-------------|------------|
| First Quarter | \$ 8.94 | \$ 6.90 |
| Second Quarter | 8.75 | 7.46 |
| Third Quarter | 8.50 | 7.25 |
| Fourth Quarter | 8.77 | 7.30 |

| Fiscal Year Ended December 31, 2010: | | |
|---|---------|---------|
| First Quarter | \$ 7.16 | \$ 6.30 |
| Second Quarter | 7.50 | 6.52 |
| Third Quarter | 7.32 | 6.40 |
| Fourth Quarter | 8.00 | 6.91 |

As of February 23, 2012, the Company had approximately 633 shareholders. The Company has never declared or paid any dividends on its Common Stock.

In prior years, the Company's board of directors had publicly announced the authorization of the Company to repurchase 250,000 shares of common stock. A total of 217,239 shares have been repurchased under this program including 270 shares repurchased during 2011. The plan allows for an additional 32,761 shares to be repurchased and does not have an expiration date.

| For Year Ended Dec. 31, 2011 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased a Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|-------------------------------------|---|-------------------------------------|--|---|
| Jan. 1 – Apr. 30 | - | - | - | 33,031 |
| May 1 – May 31 | 270 | \$7.70 | 270 | 32,761 |
| June 1 – Dec. 31 | - | - | - | 32,761 |
| | 270 | \$7.70 | 270 | 32,761 |

MANAGEMENT'S REPORT

The financial statements of IKONICS Corporation have been prepared by Company management who are responsible for their content. These statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, where appropriate, reflect estimates based on judgements of management.

The financial statements have been audited by McGladrey & Pullen LLP, an independent registered public accounting firm.

The Audit Committee of the Board of Directors, comprised of outside directors, meets periodically with the independent auditors and management to discuss the company's internal accounting controls and financial reporting matters. Our independent registered public accounting firm has unrestricted access to the Audit Committee, without management present, to discuss the results of their audit, the adequacy of internal accounting controls, and the quality of financial reports.

WILLIAM C. ULLAND
Chairman, President & CEO

JON GERLACH
Chief Financial Officer & V.P. Finance

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control system is designed to provide reasonable assurance to our management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

- Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2011. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control – Integrated Framework. Based on management's assessment and those criteria, management believes that, as of December 31, 2011, the Company maintained effective internal control over financial reporting.

WILLIAM C. ULLAND

Chairman, President & CEO

JON GERLACH

Chief Financial Officer & V.P. Finance

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND STOCKHOLDERS
IKONICS CORPORATION

We have audited the accompanying balance sheets of IKONICS Corporation as of December 31, 2011 and 2010, and the related statements of income, stockholders' equity, and cash flows for the years 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 audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of IKONICS Corporation as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ McGladrey & Pullen, LLP
Minneapolis, Minnesota
March 6, 2012

BALANCE SHEETS

DECEMBER 31, 2011 AND 2010

ASSETS

| | 2011 | 2010 |
|--|----------------------|----------------------|
| CURRENT ASSETS: | | |
| Cash (Note 7) | \$ 1,867,165 | \$ 1,291,383 |
| Short-term investments | 1,835,003 | 2,217,990 |
| Trade receivables, less allowance of \$51,000 in 2011 and \$60,000 in 2010 (Notes 5, 7, and 8) | 2,180,947 | 1,883,428 |
| Inventories (Notes 1 and 8) | 2,234,834 | 2,198,064 |
| Prepaid expenses and other assets | 82,923 | 63,965 |
| Income tax receivable | 59,322 | - |
| Deferred income taxes (Note 2) | 144,000 | 157,000 |
| Total current assets | 8,404,194 | 7,811,830 |
| PROPERTY, PLANT, AND EQUIPMENT, AT COST: | | |
| Land and building | 5,982,799 | 5,888,445 |
| Machinery and equipment | 3,021,053 | 2,455,238 |
| Office equipment | 662,160 | 642,100 |
| Vehicles | 235,000 | 234,650 |
| | 9,901,012 | 9,220,433 |
| Less accumulated depreciation | 4,464,110 | 4,207,500 |
| | 5,436,902 | 5,012,933 |
| Intangible assets , less accumulated amortization of \$427,454 in 2011 and \$376,983 in 2010 (Note 3) | 326,362 | 317,168 |
| | \$ 14,167,458 | \$ 13,141,931 |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | 2011 | 2010 |
|---|----------------------|----------------------|
| CURRENT LIABILITIES: | | |
| Accounts Payable | \$ 549,532 | \$ 441,830 |
| Accrued Compensation | 244,173 | 282,196 |
| Other accrued liabilities (Note 2) | 45,210 | 45,868 |
| Income taxes payable | - | 8,090 |
| Total current liabilities | 838,915 | 777,984 |
| Deferred Income Taxes (Note 2) | 338,000 | 171,000 |
| Total liabilities | 1,176,915 | 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 1,984,587 shares in 2011 and 1,973,357 shares in 2010 (Note 6) | 198,459 | 197,336 |
| Additional paid-in capital | 2,363,150 | 2,263,176 |
| Retained earnings | 10,428,934 | 9,732,435 |
| Total stockholders' equity | 12,990,543 | 12,192,947 |
| | \$ 14,167,458 | \$ 13,141,931 |

See notes to financial statements

STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 2011 AND 2010

| | 2011 | 2010 |
|--|---------------|---------------|
| NET SALES | \$ 16,780,262 | \$ 16,517,338 |
| COST OF GOODS SOLD | 10,070,852 | 9,713,054 |
| GROSS PROFIT | 6,709,410 | 6,804,284 |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES | 5,171,147 | 4,574,452 |
| RESEARCH AND DEVELOPMENT EXPENSES | 512,259 | 695,593 |
| | 5,683,406 | 5,270,045 |
| INCOME FROM OPERATIONS | 1,026,004 | 1,534,239 |
| INTEREST INCOME | 17,253 | 19,681 |
| INCOME BEFORE INCOME TAXES | 1,043,257 | 1,553,920 |
| FEDERAL AND STATE INCOME TAXES (NOTE 2) | 345,000 | 440,000 |
| NET INCOME | \$ 698,257 | \$ 1,113,920 |
| EARNINGS PER COMMON SHARE: | | |
| Basic | \$ 0.35 | \$ 0.56 |
| Diluted | \$ 0.35 | \$ 0.56 |
| WEIGHTED AVERAGE COMMON SHARES: | | |
| Basic | 1,981,848 | 1,971,717 |
| Diluted | 1,986,041 | 1,973,447 |

See notes to financial statements.

STATEMENTS OF STOCKHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 2011 AND 2010

| | Common Shares | Stock Amount | Additional Paid-In Capital | Retained Earnings | Total Stockholders' Equity |
|---|---------------|--------------|-------------------------------|-------------------|-------------------------------|
| Balance At December 31, 2009 | 1,967,057 | \$ 196,706 | \$ 2,198,289 | \$ 8,631,091 | \$ 11,026,086 |
| Net Income | - | - | - | 1,113,920 | 1,113,920 |
| Exercise of stock options | 8,500 | 850 | 36,890 | - | 37,740 |
| Common Stock Repurchased | (2,200) | (220) | (2,334) | (12,576) | (15,130) |
| Tax benefit resulting from stock option exercises | - | - | 914 | - | 914 |
| Stock based compensation and related tax benefit | - | - | 29,417 | - | 29,417 |
| Balance At December 31, 2010 | 1,973,357 | 197,336 | 2,263,176 | 9,732,435 | 12,192,947 |
| Net income | - | - | - | 698,257 | 698,257 |
| Exercise of stock options | 11,500 | 1,150 | 72,060 | - | 73,210 |
| Common stock repurchased | (270) | (27) | (294) | (1,758) | (2,079) |
| Tax benefit resulting from stock option exercises | - | - | 1,518 | - | 1,518 |
| Stock based compensation and related tax benefit | - | - | 26,690 | - | 26,690 |
| Balance At December 31, 2011 | 1,984,587 | \$ 198,459 | \$ 2,363,150 | \$ 10,428,934 | \$ 12,990,543 |

SEE NOTES TO FINANCIAL STATEMENTS.

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2011 AND 2010

| | 2011 | 2010 |
|---|--------------|--------------|
| CASH FLOW FROM OPERATING ACTIVITIES: | | |
| Net Income | \$ 698,257 | \$ 1,113,920 |
| ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES: | | |
| Depreciation | 415,821 | 402,027 |
| Amortization | 50,471 | 51,407 |
| Stock based compensation | 26,690 | 29,417 |
| Gain on sale of equipment and vehicles | (1,353) | (13,766) |
| Loss on intangible asset abandonment | 805 | 31,372 |
| Deferred income taxes | 180,000 | 15,000 |
| CHANGES IN WORKING CAPITAL COMPONENTS: | | |
| Trade receivables | (297,519) | 132,370 |
| Inventories | (263,809) | (127,462) |
| Prepaid expenses and other assets | (18,958) | (2,628) |
| Income tax refund receivable | (59,322) | - |
| Accounts payable | 107,702 | 155,220 |
| Accrued liabilities | (38,681) | (113,709) |
| Income taxes payable | (6,572) | (71,799) |
| Net cash provided by operating activities | 793,532 | 1,601,369 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (621,598) | (189,150) |
| Proceeds from sale of equipment and vehicles | 10,200 | 22,200 |
| Purchases of intangibles | (60,470) | (54,407) |
| Purchases of short-term investments | (2,446,359) | (2,621,393) |
| Proceeds from sale of short-term investments | 2,829,346 | 1,205,568 |
| Net cash used in investing activities | (288,881) | (1,637,182) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Repurchase of common stock | (2,079) | (15,130) |
| Proceeds from exercise of stock options | 73,210 | 37,740 |
| Net cash provided by (used in) financing activities | 71,131 | 22,610 |
| NET INCREASE (DECREASE) IN CASH | 575,782 | (13,203) |
| CASH AT BEGINNING OF YEAR | 1,291,383 | 1,304,586 |
| CASH AT END OF YEAR | \$ 1,867,165 | \$ 1,291,383 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Cash paid for income taxes, net of refunds received of \$4,090 and \$81,422, respectively | \$ 230,894 | \$ 531,799 |
| SUPPLEMENTAL SCHEDULE OF NONCASH OPERATING AND INVESTING ACTIVITIES | | |
| Equipment transferred from inventory to property, plant and equipment | \$ 227,039 | - |

See notes to financial statements

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2011 AND 2010

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business and Foreign Export Sales - IKONICS Corporation (the Company) develops and manufactures high-quality photochemical imaging systems for sale primarily to a wide range of printers and decorators of surfaces. Customers' applications are primarily screen printing and abrasive etching. The Company's principal markets are throughout the United States. In addition, the Company sells to Europe, Latin America, Asia, and other parts of the world. The Company extends credit to its customers, all on an unsecured basis, on terms that it establishes for individual customers.

Foreign export sales approximated 33.1% of net sales in 2011 and 32.8% of net sales in 2010. The Company's accounts receivable at December 31, 2011 and 2010 due from foreign customers were 35.9% and 38.5% of total accounts receivable, respectively. The foreign export receivables are composed primarily of open credit arrangements with terms ranging from 30 to 90 days. No single customer or foreign country represented greater than 10% of net sales in 2011 or in 2010.

The Company considers events or transactions that occur after the balance sheet date but before the financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosure. Subsequent events have been evaluated through March 6, 2012, the date the financial statements were issued.

A summary of the Company's significant accounting policies follows:

Short-Term Investments - Short-term investments consist of \$1,835,000 and \$2,218,000 of fully insured certificates of deposit with remaining maturities ranging from one to twelve months as of December 31, 2011 and 2010, respectively.

Trade Receivables - Trade receivables are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on an on-going basis. Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, and current economic conditions. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously written off are recorded when received. Accounts are considered past due if payment is not received according to agreed-upon terms.

A small percentage of the accounts receivable 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 end spot rate in accordance with FASB ASC 830, Foreign Currency Matters. Foreign currency transactions and translation adjustments did not have a significant effect on the Balance Sheet or the Statements of Stockholders' Equity and Cash Flows for 2011 and 2010.

Inventories - Inventories are stated at the lower of cost or market using the last-in, first-out (LIFO) method. If the first-in, first-out (FIFO) cost method had been used, inventories would have been approximately \$1,213,000 and \$993,000 higher than reported at December 31, 2011 and 2010, respectively. The major components of inventories, net of the allowance for obsolescence, are as follows:

| | 2011 | 2010 |
|------------------------|---------------------|---------------------|
| Raw Materials | \$ 1,811,219 | \$ 1,403,875 |
| Work-in-progress | 338,284 | 294,006 |
| Finished goods | 1,298,616 | 1,493,226 |
| Reduction to LIFO cost | (1,213,285) | (993,043) |
| Total Inventories | <u>\$ 2,234,834</u> | <u>\$ 2,198,064</u> |

Depreciation - Depreciation of property, plant and equipment is computed using the straight-line method over the following estimated useful lives:

| | Years |
|-------------------------------|--------------|
| Buildings..... | 15-40 |
| Machinery and equipment | 5-10 |
| Office equipment | 3-10 |
| Vehicles..... | 3 |

Intangible Assets - Intangible assets consist of patents, licenses and covenants not to compete arising from business combinations. Intangible assets are amortized on a straight-line basis over their estimated useful lives or agreement terms. Intangible assets with finite lives are assessed for impairment whenever events or circumstances indicate the carrying value may not be fully recoverable by comparing the carrying value of the intangibles to their future undiscounted cash flows. To the extent the undiscounted cash flows are less than the carrying value, analysis is performed based on several criteria, including, but not limited to, revenue trends, discounted operating cash flows and other operating factors to determine the impairment amount.

As of December 31, 2011 the remaining estimated weighted average useful lives of intangible assets are as follows:

| | Years |
|------------------------------|--------------|
| Patents..... | 15.2 |
| Licenses | 4.6 |
| Non-compete agreements | 2.5 |

Fair Value of Financial Instruments - The carrying amounts of financial instruments, including cash, short-term investments, accounts receivable, accounts payable, and accrued liabilities approximate fair value due to the short maturity of these instruments.

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 SAB 104 and FASB ASC 605 Revenue Recognition:

(a) persuasive evidence of an arrangement (principally in the form of customer sales orders and the Company's sales invoices, as generally there is no other formal agreement underlying the sale transactions)

(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 customer has no rotation or price protection rights and the Company is not under a warranty obligation except for a minimal obligation related to six months of service on the DTX printer sold in 2010. Freight billed to customers is included in sales. Shipping costs are included in cost of goods sold.

Deferred Taxes - Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. The Company follows the accounting standard on accounting for uncertainty in income taxes, which addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under this guidance, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement. The guidance on accounting for uncertainty in income taxes also addresses derecognition, classification, interest and penalties on income taxes, and accounting in interim periods.

Earnings (loss) 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, when dilutive, 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:

| | 2011 | 2010 |
|--|-----------|-----------|
| Weighted average common shares outstanding | 1,981,848 | 1,971,717 |
| Dilutive effect of stock options | 4,193 | 1,730 |
| Weighted average common and common equivalent shares outstanding | 1,986,041 | 1,973,447 |

At December 31, 2011, options to purchase 5,000 shares of common stock with a weighted average exercise price of \$8.08 were outstanding, but were excluded from the computation of common share equivalents because they were anti-dilutive. At December 31, 2010, options to purchase 16,250 shares of common stock with a weighted average exercise price of \$7.89 were outstanding, but were excluded from the computation of common share equivalents because they were anti-dilutive.

Employee Stock Plan - The Company accounts for employee stock options under the provision of ASC 718 Compensation – Stock Compensation.

Use of Estimates - The preparation of the 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 amounts 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. Significant estimates include the allowance for doubtful accounts receivable, the reserve for inventory obsolescence and the valuation allowance for deferred tax assets.

2. INCOME TAXES

Income tax expense for the years ended December 31, 2011 and 2010 consists of the following:

| | 2011 | 2010 |
|-----------------------|------------|------------|
| Current: | | |
| Federal | \$ 162,000 | \$ 428,000 |
| State | 3,000 | (3,000) |
| | 165,000 | 425,000 |
| Deferred | 180,000 | 15,000 |
| | \$ 345,000 | \$ 440,000 |

The expected provision for income taxes, computed by applying the U.S. federal income tax rate of 35% in 2011 and 2010 to income before taxes, is reconciled to income tax expense as follows:

| | 2011 | 2010 |
|---|------------|------------|
| Expected provision for federal income taxes. | \$ 365,100 | \$ 544,000 |
| State income taxes, net of federal benefit | 2,200 | (2,100) |
| Reversal of uncertain tax positions | - | (27,000) |
| Domestic manufacturers deduction | (18,600) | (50,100) |
| Non-deductible meals, entertainment, and life insurance | 20,700 | 20,400 |
| Research and development credit | (15,900) | (16,600) |
| Other | (8,500) | (28,600) |
| | \$ 345,000 | \$ 440,000 |

Net deferred tax liabilities consist of the following as of December 31, 2011 and 2010:

| | 2011 | 2010 |
|--|--------------|-------------|
| Accrued vacation | \$ 23,000 | \$ 21,000 |
| Inventories | 107,000 | 113,000 |
| Allowance for doubtful accounts | 8,000 | 12,000 |
| Allowance for sales returns | 10,000 | 11,000 |
| Capital loss carryforward | 323,000 | 323,000 |
| Less valuation allowance | (323,000) | (323,000) |
| | 148,000 | 157,000 |
| Deferred tax liabilities: | | |
| Property and equipment and other assets | (305,000) | (160,000) |
| Intangible assets | (32,000) | (11,000) |
| Prepaid expenses | (5,000) | - |
| Net deferred tax liabilities | \$ (194,000) | \$ (14,000) |

The deferred tax amounts described above have been included in the accompanying balance sheet as of December 31, 2011 and 2010 as follows:

| | 2011 | 2010 |
|------------------------|---------------------|--------------------|
| Current Assets | \$ 144,000 | \$ 157,000 |
| Noncurrent liabilities | (338,000) | (171,000) |
| | <u>\$ (194,000)</u> | <u>\$ (14,000)</u> |

At December 31, 2011 and 2010, the Company established a valuation allowance against its deferred tax asset related to the Company's \$919,000 loss on its investment in non-marketable equity securities since it is more likely that the deferred

tax asset will not be realized. The deferred tax asset and valuation allowance at December 31, 2011 and December 31, 2010 was \$323,000. As of December 31, 2011 the remaining deferred tax asset related to the capital loss can be carried back one year and carried forward three years and must be offset by a capital gain.

It has been the Company's policy to recognize interest and penalties related to uncertain tax positions in income tax expense. As of December 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 2008, 2009, 2010 and 2011.

3. INTANGIBLE ASSETS

Intangible assets consist of patents, patent applications, licenses and covenants not to compete arising from business combinations. Capitalized patent application costs are included with patents. Intangible assets are amortized on a straight-line basis over their estimated useful lives or terms of their agreement, whichever is shorter. The Company wrote off costs related to patent applications of \$1,000 in 2011 and \$31,000 in 2010. No other impairment adjustments to intangible assets were made during the years ended December 31, 2011 or 2010.

Intangible assets at December 31, 2011 and 2010 consist of the following:

| | December 31, 2011 | | December 31, 2010 | |
|-------------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortized intangible assets: | | | | |
| Patents..... | \$ 350,816 | \$ (130,166) | \$ 291,151 | \$ (123,489) |
| Licenses..... | 100,000 | (75,628) | 100,000 | (67,500) |
| Non-compete agreements..... | 303,000 | (221,660) | 303,000 | (185,994) |
| | <u>\$ 753,816</u> | <u>\$ (427,454)</u> | <u>\$ 694,151</u> | <u>\$ (376,983)</u> |

| Aggregate amortization expense: | 2011 | 2010 | Estimated amortization expense for the years ending December 31: | |
|---------------------------------|----------|----------|--|----------|
| For the years ended December 31 | \$50,471 | \$51,407 | 2012 | \$48,000 |
| | | | 2013 | 44,000 |
| | | | 2014 | 15,000 |
| | | | 2015 | 11,000 |
| | | | 2016 | 8,000 |

In connection with the license agreements, the Company has agreed to pay royalties ranging from 3% to 5% on the sales of products subject to the agreements. The Company incurred \$94,000 of expense under these agreements during 2011, and \$87,000 during 2010 which have been included in selling, general and administrative expenses in the Statements of Income.

4. RETIREMENT PLAN

The Company has established a salary deferral plan under Section 401(k) of the Internal Revenue Code. Such deferrals accumulate on a tax-deferred basis until the employee withdraws the funds. The Company contributes up to 5% of each eligible employee's compensation. Total retirement expense for the years ended December 31, 2011 and 2010 was approximately \$194,000 and \$188,000, respectively.

5. 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 Micro-Machining. 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 Micro-Machining or DTX. Beginning in 2011, the Company no longer includes Micro-Machining and DTX financial information under the IKONICS Imaging segment. The financial information for Micro-Machining 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 previous 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 previous segmentation. Financial information with respect to the reportable segments follows:

For the year ended December 31, 2011 (previous segment method):

| | Domestic | Export | IKONICS Imaging | Unallocated* | Total |
|--|--------------|--------------|-----------------|----------------|---------------|
| Net sales | \$ 6,680,562 | \$ 5,556,455 | \$ 4,543,245 | \$ - | \$ 16,780,262 |
| Cost of goods sold..... | 3,824,866 | 4,123,833 | 2,122,153 | - | 10,070,852 |
| Gross profit..... | 2,855,696 | 1,432,622 | 2,421,092 | - | 6,709,410 |
| Selling, general and Administrative* | 1,241,502 | 581,517 | 1,888,043 | 1,460,085 | 5,171,147 |
| Research and Development* | - | - | - | 512,259 | 512,259 |
| Income (loss) from Operations | \$ 1,614,194 | \$ 851,105 | \$ 533,049 | \$ (1,972,344) | \$ 1,026,004 |

For the year ended December 31, 2010 (previous segment method):

| | Domestic | Export | IKONICS Imaging | Unallocated* | Total |
|--|--------------|--------------|-----------------|----------------|---------------|
| Net sales | \$ 6,653,723 | \$ 5,420,601 | \$ 4,443,014 | \$ - | \$ 16,517,338 |
| Cost of goods sold..... | 3,497,971 | 3,792,335 | 2,422,748 | - | 9,713,054 |
| Gross profit..... | 3,155,752 | 1,628,266 | 2,020,266 | - | 6,804,284 |
| Selling, general and Administrative* | 973,623 | 571,826 | 1,128,508 | 1,900,495 | 4,574,452 |
| Research and Development* | - | - | - | 695,593 | 695,593 |
| Income (loss) from Operations | \$ 2,182,129 | \$ 1,056,440 | \$ 891,758 | \$ (2,596,088) | \$ 1,534,239 |

For the year ended December 31, 2011 (new segment method):

| | Domestic | Export | IKONICS Imaging | Other | Unallocated* | Total |
|--|--------------|--------------|-----------------|------------|--------------|---------------|
| Net sales | \$ 6,680,562 | \$ 5,556,445 | \$ 3,582,268 | \$ 960,977 | \$ - | \$ 16,780,262 |
| Cost of goods sold..... | 3,824,866 | 4,123,833 | 1,718,846 | 403,307 | - | 10,070,852 |
| Gross Profit..... | 2,855,696 | 1,432,622 | 1,863,422 | 557,670 | - | 6,709,410 |
| Selling, general and Administrative* | 1,241,502 | 581,517 | 1,136,907 | 751,136 | 1,460,085 | 5,171,147 |
| Research and Development* | - | - | - | - | 512,259 | 512,259 |
| Income (loss) from Operations | 1,614,194 | 851,105 | 726,515 | (193,466) | (1,972,344) | 1,026,004 |

* 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 December 31, 2011 and December 31, 2010 were as follows:

| | 2011 | 2010 |
|-------------------------------|--------------|--------------|
| Domestic | \$ 997,937 | \$ 874,535 |
| Export..... | 783,788 | 725,007 |
| IKONICS Imaging | 427,252 | 325,334 |
| Other, net of allowances..... | (28,030) | (41,448) |
| Total..... | \$ 2,180,947 | \$ 1,883,428 |

6. STOCK OPTIONS

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 three year period. A total of 119,823 shares of common stock are reserved for additional grants of options under the plan at December 31, 2011.

Under the plan, the Company charged compensation cost of \$26,690 and \$29,417 against income in 2011 and 2010, respectively.

As of December 31, 2011, there was approximately \$32,000 of unrecognized compensation cost related to unvested share-based compensation awards granted which is expected to be recognized over the next three years.

Proceeds from the exercise of stock options were \$73,210 for 2011 and \$37,740 for 2010.

The fair value of options granted during 2011 and 2010 were estimated using the

Black-Scholes option pricing model with the following assumptions:

| | 2011 | 2010 |
|---|-----------------|------------|
| Dividend yield..... | 0% | 0% |
| Expected volatility..... | 40.5% - 41.3% | 45.2% |
| Expected life of option..... | Five years | Five years |
| Risk-free interest rate..... | 1.0% - 2.0% | 2.5% |
| Fair values of each option on grant date..... | \$2.75 - \$2.83 | \$3.08 |

There were 9,000 options and 4,000 options granted during 2011 and 2010, respectively.

FASB ASC 718, Compensation – Stock Compensation specifies that initial accruals be based on the estimated number of instruments for which the requisite service is expected to be rendered. Therefore, the Company is required to incorporate a preexisting forfeiture rate based on the historical forfeiture expense and prospective actuarial analysis, estimated at 2%.

A summary of the status of the Company's stock option plan as of December 31, 2011 and changes during the year then ended is presented below:

| Options | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|---|----------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2011 | 40,500 | \$ 6.38 | | |
| Granted | 9,000 | 7.66 | | |
| Exercised | (11,500) | 6.37 | | |
| Expired and Forfeited | (3,250) | 7.82 | | \$ |
| Outstanding at December 31, 2011 | 34,750 | \$ 6.58 | 2.75 | \$ 45,695 |
| Vested or expected to vest at December 31, 2011 | 34,750 | \$ 6.58 | 2.75 | \$ 45,695 |
| Exercisable at December 31, 2011 | 16,916 | \$ 6.50 | 1.92 | \$ 24,111 |

The weighted-average grant date fair value of options granted was \$2.82 and \$3.08 for the years ended December 31, 2011 and 2010, respectively. The total intrinsic value of options exercised was \$20,687 for the year ended December 31, 2011 and \$24,945 for the year ended December 31, 2010.

The following table summarizes information about stock options outstanding at December 31, 2011:

| Range of Exercise Price | Options Outstanding | | | Options Exercisable | |
|-------------------------|---|---|---------------------------------|---|---------------------------------|
| | Number Outstanding at December 31, 2011 | Weighted-Average Remaining Contractual Life (years) | Weighted-Average Exercise Price | Number Exercisable at December 31, 2011 | Weighted-Average Exercise Price |
| \$5.00-\$5.99 | 13,000 | 2.31 | \$ 5.00 | 6,500 | \$ 5.00 |
| \$6.00-\$6.99 | 4,250 | 1.58 | \$ 6.71 | 4,250 | \$ 6.71 |
| \$7.00-\$8.99 | 17,500 | 3.36 | \$ 7.73 | 6,166 | \$ 7.95 |
| | 34,750 | 2.75 | \$ 6.58 | 16,916 | \$ 6.50 |

7. CONCENTRATION OF CREDIT RISK

The Company maintains its cash balances primarily at one financial institution in a partially insured checking account that does not provide for interest. Instead, the account earns credits which offset banking fees.

Accounts receivable are financial instruments that also expose the Company to concentration of credit risk. The large number of customers comprising the Company's customer base and their dispersion across different geographic areas limits such exposure. In addition, the Company routinely assesses the financial strength of its customers and maintains an allowance for doubtful accounts that management believes will adequately provide for credit losses.

8. LINE OF CREDIT

The Company has a \$1,250,000 bank line of credit that provides for working capital financing. This line of credit is subject to annual renewal on each October 30, is collateralized by trade receivables and inventories, and bears interest at 2.5 percentage points over 30-day LIBOR. There were no outstanding borrowings under this line of credit at December 31, 2011 and 2010. There are no financial covenants related to the line of credit.

COMMON STOCK

IKONICS Corporation common stock is traded on the Nasdaq Capital Market under the symbol IKNX. For investment and stock information contact:

JON GERLACH
Chief Financial Officer

IKONICS Corporation
4832 Grand Avenue, Duluth, MN 55807
Phone: (218) 628-2217
email: jgerlach@ikonics.com

TRANSFER AGENT

WELLS FARGO SHAREOWNER SERVICES
PO Box 64854
St. Paul, MN 55164-0854

Shareholders with questions on stock holdings, transfer requirements and address changes contact Wells Fargo Bank at: (800) 468-9716

AUDITOR

MCGLADREY & PULLEN LLP
801 Nicolet Mall, Suite 110 West Tower
Minneapolis, MN 55802
(612) 573-8750

COUNSEL

HANFT FRIDE
1000 U.S. Bank Place
130 W. Superior Street
Duluth, MN 55802
(218) 722-4766

ADDITIONAL FINANCIAL INFORMATION

Stockholders of record automatically receive quarterly earnings information, and street name holders may do so upon written request. For a copy of the Form 10-K, as filed with the Securities and Exchange Commission, and other financial information available at no charge to stockholders, please contact:

JON GERLACH
Chief Financial Officer

IKONICS Corporation
4832 Grand Avenue, Duluth, MN 55807
Phone: (218) 628-2217
email: jgerlach@ikonics.com

ANNUAL MEETING

The Company's annual meeting will be held:

April 26, 2012 1:00 p.m.

Kitchi Gammi Club
831 E. Superior Street
Duluth, MN 55802

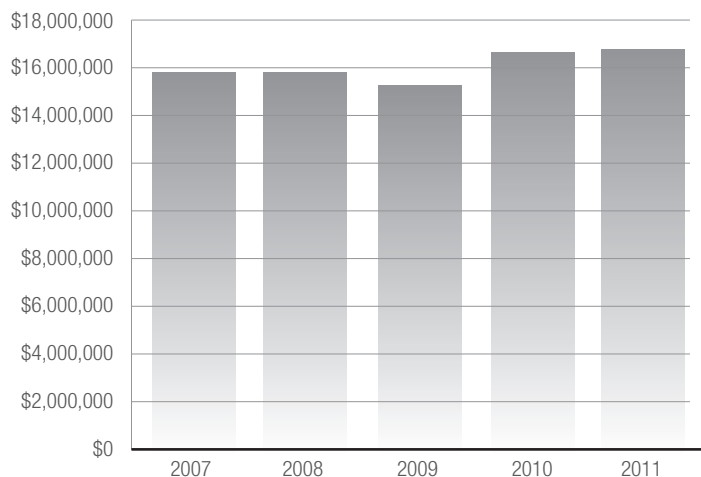
BOARD OF DIRECTORS

| | |
|---------------------|--|
| DAVID O. HARRIS | President David O. Harris, Inc Minneapolis, MN Director Since 1965 |
| RONDI C. ERICKSON | Co-Owner Nokomis Restaurant Duluth, MN Director Since 2000 |
| LOCKWOOD CARLSON | President Carlson Consulting Group Minneapolis, MN Director Since 2009 |
| CHARLES H. ANDRESEN | Attorney Andresen & Butterworth P.A. Duluth, MN Director Since 1979 |
| H. LEIGH SEVERANCE | President Severance Capital Management Denver, CO Director Since 2000 |
| GERALD W. SIMONSON | President Omnetics Connector Corporation Minneapolis, MN Director Since 1978 |
| WILLIAM C. ULLAND | Chairman, President & CEO IKONICS Corporation Duluth, MN Director Since 1972 |

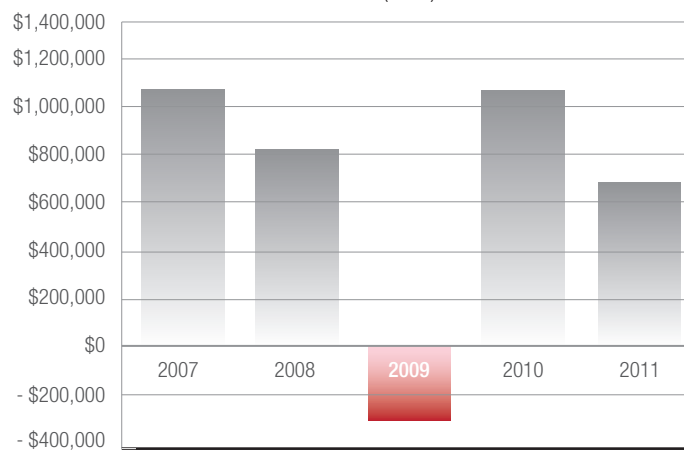
CORPORATE OFFICERS

| | |
|-------------------|--------------------------------------|
| WILLIAM C. ULLAND | Chairman, President & CEO |
| CLAUDE PIGUET | Executive Vice President |
| JON GERLACH | Vice President, Finance, CFO |
| PARNELL THILL | Vice President, Marketing |
| ROBERT D. BANKS | Vice President, International |

Net Sales 2007 - 2011



Net Income (Loss) 2007 - 2011



IKONICS Five-Year History

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|--|--------------|--------------|--------------|--------------|--------------|
| Net Sales | \$15,824,725 | \$15,854,484 | \$15,121,617 | \$16,517,338 | \$16,780,262 |
| Pretax Income (Loss) | \$1,635,775 | \$1,085,134 | \$(11,360) | \$1,553,920 | \$1,043,257 |
| Net Income (Loss) | \$1,169,775 | \$814,134 | \$(307,360) | \$1,113,920 | \$698,257 |
| Net Cash Provided by Operations | \$1,697,695 | \$1,125,668 | \$1,374,114 | \$1,601,369 | \$793,532 |
| Return on Sales | 7.4% | 5.1% | (2.0%) | 6.7% | 4.2% |
| Return on Assets | 9.8% | 6.5% | (2.6%) | 8.5% | 4.9% |
| Return on Avg. Stockholders' Equity | 11.2% | 7.2% | (2.7%) | 9.6% | 5.5% |
| Debt to Equity | 8.5% | 9.2% | 8.8% | 7.8% | 9.1% |
| Diluted EPS | \$0.57 | \$0.40 | \$(0.16) | \$0.56 | \$0.35 |
| Stock price: High | \$10.45 | \$10.50 | \$8.29 | \$8.00 | \$8.94 |
| Low | \$7.22 | \$5.25 | \$4.00 | \$6.30 | \$6.90 |
| Close | \$9.28 | \$5.74 | \$6.30 | \$7.25 | \$7.57 |
| Weighted Average Common Shares Outstanding - Diluted | 2,063,380 | 2,053,733 | 1,973,739 | 1,973,447 | 1,986,041 |
| Total Assets | \$11,982,417 | \$12,486,429 | \$11,997,272 | \$13,141,931 | \$14,167,458 |
| Total Liabilities | \$936,703 | \$1,052,789 | \$971,186 | \$948,984 | \$1,176,915 |
| Total Stockholders' Equity | \$11,045,714 | \$11,433,640 | \$11,026,086 | \$12,192,947 | \$12,990,543 |
| Capital Spending | \$609,772 | \$4,472,681 | \$90,313 | \$189,150 | \$621,598 |

