MIKROS SYSTEMS CORP

FORM 10-Q
(Quarterly Report)

Filed 08/14/17 for the Period Ending 06/30/17

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CIK	0000317340
Symbol	MKRS
SIC Code	3829 - Measuring and Controlling Devices, Not Elsewhere Classified
Industry	Electrical Components & Equipment
Sector	Industrials
Fiscal Year	12/31

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2017

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: 000-14801

Mikros Systems Corporation
(Exact name of registrant as specified in its charter)

Delaware	**14-1598200**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

707 Alexander Road, Building Two, Suite 208, Princeton, New Jersey 08540
(Address of Principal Executive Offices)

(609) 987-1513
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	☐		Accelerated filer	☐
Non-accelerated filer	☐	(Do not check if a smaller reporting company)	Smaller reporting company	☒
Emerging growth company	☐			

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: There were 35,551,775 issued and outstanding shares of the issuer's common stock, $.01 par value per share, on August 14, 2017.

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Part I Financial Information

Item 1 Financial Statements

Mikros Systems Corporation
Balance Sheets
(Unaudited)

	June 30, 2017	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 992,460	$ 858,868
Receivables on government contracts	1,533,784	1,704,301
Prepaid expenses and other current assets	77,104	55,144
Total current assets	2,603,348	2,618,313
Property and equipment		
Equipment	113,478	95,693
Leasehold improvements	21,306	-
Furniture & fixtures	37,557	16,394
Less: accumulated depreciation	(93,501)	(86,436)
Property and equipment, net	78,840	25,651
Intangible assets	133,625	128,916
Less: accumulated amortization	(43,524)	(32,947)
Intangible assets, net	90,101	95,969
Deferred tax assets	141,832	204,991
Total assets	$ 2,914,121	$ 2,944,924
Liabilities and shareholders' equity		
Current liabilities:		
Accrued payroll and payroll taxes	$ 516,856	$ 460,434
Accounts payable and accrued expenses	292,068	338,872
Accrued warranty expense	-	240,980
Deferred revenue	25,000	7,500
Total current liabilities	833,924	1,047,786
Long-term liabilities	139,343	140,377
Total liabilities	973,267	1,188,163
Shareholders' equity:		
Preferred stock, convertible, par value $.01 per share, authorized 5,000,000 shares, none issued and outstanding	-	-
Common stock, par value $.01 per share, authorized 60,000,000 shares, issued and outstanding 35,546,775 and 35,424,775 shares, respectively	355,469	354,249
Capital in excess of par value	10,078,235	10,061,894
Accumulated deficit	(8,492,850)	(8,659,382)
Total shareholders' equity	1,940,854	1,756,761
Total liabilities and shareholders' equity	$ 2,914,121	$ 2,944,924

See Notes to Unaudited Condensed Financial Statements

Mikros Systems Corporation
Condensed Statements of Operations and Comprehensive Income (unaudited)

	Three Months Ended,		Six Months Ended,	
	June 30, 2017	June 30, 2016	June 30, 2017	June 30, 2016
Contract Revenues	$ 1,740,863	$ 978,372	$ 3,495,836	$ 1,966,301
Cost of sales	621,582	349,526	1,273,118	673,854
Gross margin	1,119,281	628,846	2,222,718	1,292,447
Expenses:				
Engineering	539,412	312,849	1,056,592	636,762
General and administrative	430,384	296,754	839,287	632,902
Total expenses	969,796	609,603	1,895,879	1,269,664
Income from operations	149,485	19,243	326,839	22,783
Other income:				
Interest	724	1,256	1,453	2,705
Net income before income taxes	150,209	20,499	328,292	25,488
Income tax expense	73,985	12,512	161,760	15,655
Net income	76,224	7,987	166,532	9,833
Discount upon exchange of Preferred Stock, net of related fees	-	1,103,597	-	1,103,597
Net income available to common shareholders	$ 76,224	$ 1,111,584	$ 166,532	$ 1,113,430
Income per common share - basic	$ -	$ 0.03	$ -	$ 0.03
Basic weighted average number of shares outstanding	35,528,094	32,419,016	35,091,624	32,224,577
Income per common share - diluted	$ -	$ 0.03	$ -	$ 0.03
Diluted weighted average number of shares outstanding	35,845,082	35,506,914	35,367,136	35,554,403

See Notes to Unaudited Condensed Financial Statements

Mikros Systems Corporation
Statements of Shareholders' Equity

	Preferred Stock $0.01 Par Value		Common Stock $0.01 Par Value				
	Number of shares	Par Value	Number of shares	Par Value	Capital in Excess of Par Value	Accumulated Deficit	Total
Balance at January 1, 2017	-	$ -	35,424,775	$ 354,249	$ 10,061,894	$ (8,659,382)	$ 1,756,761
Stock compensation	-	-	-	-	6,211	-	6,211
Exercise of non-restricted stock awards	-	-	62,000	620	10,730	-	11,350
Restricted common shares issued	-	-	60,000	600	(600)		-
Net income	-	-	-	-	-	166,532	166,532
Balance at June 30, 2017	-	$ -	35,546,775	$ 355,469	$ 10,078,235	$ (8,492,850)	$ 1,940,854

See Notes to Unaudited Condensed Financial Statements

Mikros Systems Corporation
Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30	
	2017	**2016**
Cash flows from operating activities		
Net income	$ 166,532	$ 9,833
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	19,423	18,788
Deferred tax expense	63,159	(7,637)
Share-based compensation expense	6,211	1,250
Changes in assets and liabilities:		
Decrease (increase) in receivables on government contracts	170,517	(33,617)
Iincrease in prepaid expenses and other current assets	(21,960)	(39,680)
Increase (decrease) in accrued payroll and payroll taxes	56,422	(325,911)
(Decrease) in accounts payable and accrued expenses	(46,804)	(271,943)
(Decrease) in accrued warranty expense	(240,980)	(35,079)
Increase in deferred revenue	17,500	6,000
(Decrease) increase in long-term liabilities	(1,034)	10,879
Net cash provided by (used in) operating activities	188,986	(667,117)
Cash flows from investing activities:		
Payments related to intangible assets	(4,709)	(1,333)
Purchase of property and equipment	(62,035)	-
Net cash used in investing activities:	(66,744)	(1,333)
Cash flows from financing activities:		
Exercise of stock options	11,350	350
Payments to preferred shareholders in conjunction with a recapitalization	-	(362,213)
Payments to acquire and retire Common Stock	-	(147,451)
Professional fees paid in conjunction with recapitalization	-	(46,090)
Net cash provided by (used in) financing activities:	11,350	(555,404)
Net increase (decrease) in cash and cash equivalents	133,592	(1,223,854)
Cash and cash equivalents, beginning of period	858,868	2,858,655
Cash and cash equivalents, end of period	$ 992,460	$ 1,634,801
Supplement cash flow information:		
Cash paid during the period for income taxes	$ 45,000	$ 44,500
Noncash investing and financing activities:		
Issuance of common stock in in exchange for preferred stock		$ 442,750
Recognition of an extinguishment liability in exchange for preferred stock		$ 33,941

See Notes to Unaudited Condensed Financial Statements

Mikros Systems Corporation
Notes to Condensed Financial Statements
(unaudited)

Note 1 – Basis of Presentation

The financial statements included herein have been prepared by Mikros Systems Corporation (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). 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 pursuant to such rules and regulations. These condensed financial 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, 2016.

In the opinion of the Company's management, the accompanying unaudited interim condensed financial statements contain all adjustments, consisting solely of those which are of a normal recurring nature, necessary to present fairly its financial position as of June 30, 2017, the results of its operations for the three and six months ended June 30, 2017 and 2016, changes in stockholders' equity from January 1, 2017 to June 30, 2017and cash flows for the six months ended June 30, 2017 and 2016.

Note 2 – Recent Accounting Pronouncements

There have been no developments to recently issued accounting standards, including the expected dates of adoption and estimated effects on the Company's condensed financial statements, from those disclosed in the Company's 2016 Annual Report on Form 10-K.

Note 3 – Significant Accounting Policies

Revenue Recognition

The Company is engaged in research and development contracts with the federal government to develop certain technology to be utilized by the U.S. Department of Defense ("DoD"). The contracts are cost plus fixed fee contracts and revenue is recognized on the basis of such measurement of partial performance as will reflect reasonably assured realization or delivery of completed articles. Fees earned under the Company's contracts may also be accrued as they are billable, under the terms of the agreements, unless such accrual is not reasonably related to the proportionate performance of the total work or services to be performed by the Company from inception to completion. Under the terms of certain contracts, fixed fees are not recognized until the receipt of full payment has become unconditional, that is, when the product has been delivered and accepted by the federal government. Backlog represents the estimated amount of future revenues to be recognized under negotiated contracts as work is performed. The Company's backlog includes future Adaptive *Diagnostic Electronic Portable Testset* ("ADEPT") units to be developed and delivered to the federal government.

The Company recognizes revenue as it relates to the license of software when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collection is probable. The sale and/or license of software products and technology is deemed to have occurred when a customer either has taken possession of or has access to take immediate possession of the software or technology. Software license agreements include post-contract customer support ("PCS"). For the Company's software and software-related multiple element arrangements, where customers purchase both software related products and software related services, the Company uses vendor-specific objective evidence ("VSOE") of fair value for software and software-related services to separate the elements and account for them separately. VSOE exists when a company can support what the fair value of its software and/or software-related services is based on evidence of the prices charged when the same elements are sold separately. VSOE of fair value is required, generally, in order to separate the accounting for various elements in a software and related services arrangement. The Company has established VSOE of fair value for the majority of the PCS, professional services, and training. Given the limited number of sales related to this software, and the fact that the Company does not sell the PCS element separately, there is no VSOE currently available to bifurcate the PCS element from the contract. In accordance with Accounting Standards Codification Topic 985-605-25-10a, the fees earned from sale of licenses to which the only undelivered element is the PCS, are recognized ratably over the life of the contract. Revenues from the sale of software licenses and maintenance for the three and six months ended June 30, 2017 and 2016 were $5,000 and $33,751 and $12,500 and $61,501, respectively. At June 30, 2017 and December 31, 2016, deferred revenues amounted to $25,000 and $7,500, respectively.

Unbilled revenue reflects work performed, but not billed at the time, per contractual requirements. As of June 30, 2017 and December 31, 2016, the Company had unbilled revenues of $103,136 and $235,421, respectively which are recorded within receivables on government contracts in the Company's balance sheet. Billings to customers in excess of revenue earned are classified as advanced billings, and shown as a liability. As of June 30, 2017 and December 31, 2016, there were no advanced billings.

Warranty Expense

The Company provides a limited warranty, as defined by the related warranty agreements, for its production units. The Company's warranties require the Company to repair or replace defective products during such warranty period. The Company estimates the costs that may be incurred under its warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of units sold, expected and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liability and adjusts the amount as necessary. During the three months ended June 30, 2017 and 2016, the Company recognized a warranty benefit of $97,560 and $0, respectively, and for the six months ended June 30, 2017 and 2016, the Company recognized a warranty benefit of $238,967 and $20,801, respectively. Since the inception of the ADEPT IDIQ contract in March 2010, the Company has delivered 189 ADEPT units. As of June 30, 2017, no ADEPT units remain under the limited warranty coverage.

The following table reflects the reserve for product warranty activity for:

	June 30, 2017	December 31, 2016
Balance, beginning of the year	$ 240,980	$ 359,654
Provision for product warranty	-	1,800
Product warranty expirations	(238,967)	(86,301)
Product warranty costs paid	(2,013)	(34,173)
Balance, end of the period	$ -	$ 240,980

Research and Development Expense

Research and Development expenditures for research and development of the Company's products are expensed when incurred, and are included in general and administrative expenses. The Company recognized research and development costs as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2017	**2016**	**2017**	**2016**
Salaries	$ 51,473	$ 17,452	$ 91,079	$ 37,004
Other costs	25,263	6,907	27,452	8,252
	$ 76,736	$ 24,359	$ 118,531	$ 45,256

Intangible Assets

The majority of the Company's intangible assets is a license acquired during 2015. In July 2015, the Company purchased certain software products, intellectual property and related assets from VSE Corporation. The primary software programs purchased were the Prognostics Framework (PF) and Diagnostic Profiler (DP) programs. The Diagnostic Profiler software is used worldwide by several multinational companies for optimized maintenance of diverse product lines. The Diagnostic Profiler is also used by the US Air Force for depot test programs, and Prognostics Framework is used by the US Army for several missile defense systems.

Licenses are amortized using a straight-line method over their estimated life of six years. For the three and six months ended June 30, 2017 and 2016, amortization expense related to the Company's license amounted to $5,250 and $5,250 and $10,500 and $10,500, respectively, and are included in general and administrative expenses on the Statements of Operations and Comprehensive Income.

Note 4 – Income Per Share

Net income per common share information is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	**2016**	**2017**	**2016**
Basic earnings per common share:				
Net income	$ 76,224	$ 7,987	$ 166,532	$ 9,833
Discount upon exchange of Preferred Stock, net of related fees	-	1,103,597	-	1,103,597
	76,224	1,111,584	166,532	1,113,430
Portion allocable to common shareholders	100.0%	99.3%	100.0%	99.3%
Net income available to common shareholders	$ 76,224	$ 1,103,803	$ 166,532	$ 1,105,636
Weighted average basic shares outstanding	35,528,094	32,419,016	35,091,624	32,224,577
Basic (loss) income per common share	$ -	$ 0.03	$ -	$ 0.03
Dilutive earnings per common share:				
Net income allocable to common shareholders	$ 76,224	$ 1,103,803	$ 166,532	$ 1,105,636
Add: undistributed earnings allocated to participating securities	-	7,781	-	7,794
Numerator for diluted earnings per common share	76,224	1,111,584	166,532	1,113,430
Weighted average shares outstanding - basic	35,528,094	32,419,016	35,091,624	32,224,577
Diluted effect:				
Stock options	88,380	7,636	74,317	7,636
Unvested restricted stock units	228,608	1,818	201,195	1,818
Conversion equivalent of dilutive Series B Convertible Preferred Stock	-	2,865,477	-	3,086,388
Conversion equivalent of dilutive Convertible Preferred Stock	-	212,967	-	233,984
Weighted average dilutive shares outstanding	35,845,082	35,506,914	35,367,136	35,554,403
Dilutive income per common share	$ -	$ 0.03	$ -	$ 0.03

The table below sets forth the calculation of the percentage of net earnings allocable to common shareholders under the two-class method in 2016.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Numerator:				
Weighted average participating common shares	35,528,094	32,419,016	35,091,624	32,224,577
Denominator:				
Weighted average participating common shares	35,528,094	32,419,016	35,091,624	32,224,577
Add: Weighted average shares of Convertible Preferred Stock	-	212,967	-	233,984
Weighted average participating shares	35,528,094	32,631,983	35,091,624	32,458,561
Portion allocable to common shareholders	100.0%	99.3%	100.0%	99.3%

Diluted net income per share for the three and nine months ended June 30, 2017 and 2016 does not reflect the following potential common shares, as the effect would be antidilutive.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Stock options	335,000	610,000	335,000	610,000
Unvested restricted stock	60,000	-	60,000	-

Note 5 – Income Tax Matters

The Company conducts an on-going analysis to review its net deferred tax asset and the need for a related valuation allowance. As a result of this analysis and the actual results of operations, the net deferred tax assets decreased by $63,159 and increased by $7,637 during the six months ended June 30, 2017 and 2016, respectively. The change in deferred tax assets is attributable to the reversal of various book/tax differences. utilization of income tax attributes, primarily federal net operating losses, as the Company anticipates annual earnings from operations to continue.

Note 6 – Stock-Based Compensation

During 2017, the Company issued 60,000 shares of restricted stock with a weighted average fair value of $0.46 per share. As of June 30, 2017, there was $26,375 of unrecognized stock-based compensation expense related to the restricted stock issued during 2017, which will be recognized in future periods. During the six months ended June 30, 2017, 62,000 options were exercised for proceeds amounting to $11,350. The intrinsic value of the options as of June 30, 2017 is $63,250.

During the three and six months ended June 30, 2017 and 2016, the Company recognized stock-based compensation expense of $3,572 and $636 and $6,211 and $1,250, respectively.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains "forward-looking statements" – that is, statements related to future, not past, events. In this context, forward-looking statements often address our expected future business and financial performance and financial condition, and often contain words such as "expect," "anticipate," "intend," "plan," "believe," "seek," "see," or "will." These forward- looking statements are not guarantees and are subject to known and unknown risks, uncertainties and assumptions about us that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. For us, particular uncertainties that could cause our actual results to be materially different than those expressed in our forward- looking statements include: changes in business conditions; a decline or redirection of the U.S. defense budget; the termination of any contracts with the U.S. Government; changes in our sales strategy and product development plans; changes in the marketplace; continued services of our executive management team; our limited marketing experience; competition between us and other companies seeking Small Business Innovative Research ("SBIR") grants; competitive pricing pressures; market acceptance of our products under development; delays in the development of products; our ability to adequately integrate our new software offerings into our business model, our ability to develop and market solutions for commercial customers, numerous other matters of national, regional and global scale, including those of a political, economic, business and competitive nature; statements of assumption underlying any of the foregoing, as well as other factors set forth under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2016 filed with the Securities and Exchange Commission. All subsequent written and oral forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by the foregoing. Except as required by law, we assume no duty to update or revise our forward-looking statements.

Item 2. Management's Discussion and Analysis of Financial Position and Results of Operations.

Mikros Systems Corporation (the "Company", "we" or "us") designs and manufactures software, hardware and electronic systems used to maintain complex distributed systems. Examples of such systems include defense equipment such as radars and combat systems, and commercial and industrial applications such as printing presses, power distribution and utility systems, and Federal Aviation Administration ("FAA") systems.

Over the past decade, our principal customer has been the U.S. Department of Defense, primarily the U.S. Navy. We provide the following two key systems to the Navy for maintenance of radars and combat systems:

- ADEPT®, the Adaptive Diagnostic Electronic Portable Testset, is a PC-based maintenance automation workstation used to maintain the Navy's premier AN/SPY-1 phased array radar on cruisers and destroyers.
- ADSSS, the ADEPT Distance Support Sensor Suite, is a Condition-Based Maintenance (CBM) system used to monitor Combat System Elements (CSEs) onboard the Littoral Combat Ship (LCS).

More recently, we have developed and marketed software products to analyze maintenance data collected from target systems, optimize maintenance procedures, and predict failures. Our Prognostics Framework® (PF) and Diagnostic Profiler® (DP) products provide software capabilities which complement our maintenance hardware products (ADEPT and ADSSS), and allow us to provide complete hardware/software solutions for advanced maintenance, particularly of complex distributed systems. Now that we have a complete hardware/software solution for advanced maintenance, we are expanding into commercial and industrial markets.

Product Portfolio

Adaptive Diagnostic Electronic Portable Testset (ADEPT®). ADEPT is an automated maintenance workstation designed to significantly reduce the time required to align the AN/SPY-1 Radar System aboard U.S. Navy Aegis cruisers and destroyers, while optimizing system performance and readiness. ADEPT Systems are currently deploying on all Aegis CG and DDG platforms to support the AN/SPY1 radar system. ADEPT represents an innovative approach to Navy shipboard maintenance, integrating modular instrumentation cards in a rugged enclosure with an onboard computer, input and output devices, networking hardware, removable hard drives, and a touch-screen display. A custom software application provides the user interface and integrates the hardware with a database that stores user information, instrument readings, maintenance requirements, and training aids. ADEPT is designed to be adapted to other complex shipboard systems, and provide integrated distance support capabilities for remote diagnostics and troubleshooting by shore-based Navy experts.

Since the system uses commercial instrument case and modules, ADEPT units can be modified to support both preventative maintenance and condition-based maintenance of other radars and complex electronic systems in military or commercial applications. In that regard, we have a service contract with the U.S. Navy to extend ADEPT to a second U.S. Navy radar system, the SPS-49. These services are expected to assist in optimizing performance for the Ballistic Missile Defense Mission. As of the date of this report, we have delivered a total of 189 ADEPT units.

Adaptive Distance Support Sensor Suite (ADSSS). In 2013, we started development of the ADEPT Distance Support Sensor Suite, or ADSSS, for the Navy's Littoral Combat Ship ("LCS"). The LCS is the U.S. Navy's latest combat warship. ADSSS is a network-enabled system that can be configured to monitor multiple shipboard systems and report maintenance data onshore for further analysis to detect trends and predict failures. ADSSS provides an open architecture approach with industry standard hardware, and cybersecurity compliant software to acquire and process system operational and maintenance data. ADSSS fully automates the capture of system operation, environment and maintenance data to provide unattended operation. The system monitors key parameters and sends alert notifications when parameters move out of tolerance.

A pilot version of ADSSS has been deployed on the LCS Class since 2014. Development of the production system is ongoing and initial shipboard testing was completed in 2016 **.** In July, 2017, we installed the first ADSSS system on the LCS Class. We expect ADSSS to be used on both variants of the LCS, currently planned to be at least 32 ships. ADSSS, with its remote monitoring and prognostics capabilities, has also generated interest in other ship classes, including Aegis, and we are currently pursuing several related opportunities.

Diagnostic Profiler. The Diagnostic Profiler is an integrated development environment for developing diagnostic capabilities used in maintenance, embedded diagnostics and troubleshooting applications. The software provides diagnostic services to its host application, including fault call-outs, suggested "next best" test to further isolate faults, and direct maintenance actions. When additional faults are identified, the software prioritizes the fault call-outs by probability. The use of the diagnostic profiler eliminates the need for the development and maintenance of diagnostic flow charts and hard-coded text sequences. This reduces the effort required to correct bugs and design changes and over the life of the system, could result in significant cost savings.

Prognostics Framework. Prognostics Framework is an analysis software for framework that implements real-time prognostics, diagnostics and status monitoring to support embedded prognostic applications, health management systems and condition-based maintenance applications. The Prognostics Framework software institutes an information framework that organizes relevant data related to: (i) the condition of the system; (ii) the system's ability to perform required functions over specific time intervals; and (iii) the need for maintenance actions and repair parts. The Prognostics Framework has been used to implement a complete health management system on one of the first radar systems to require prognostics as a key element of its overall solutions. Other potential applications include complex computer networks, power generators, power supply, cooling and environmental systems.

Government Contracts

In September 2016 we were awarded and entered into a multi-year IDIQ contract with the Naval Surface Warfare Center, Port Hueneme Division, relating to the ADSSS product. The contract has a term of five years and provides for the purchase and sale of up to $48 million of ADSSS units and related engineering and logistics support. The first delivery order in the amount of $3.0 million was awarded on September 15, 2016, to perform installations, support, and logistics for the LCS class.

In February 2017 we were awarded a follow-on multi-year Small Business Innovation Research (SBIR) Phase III IDIQ contract with the Naval Surface Warfare Center, Crane Division, for our ADEPT program. The contract provides for the purchase and sale of up to $35.1 million of ADEPT units and related engineering, such as calibration, repair, training and other sustainment services. The first delivery order for $1.1 million was also awarded in February 2017 to build eleven ADEPT systems for continuing fleet support on all Aegis cruisers and destroyers.

In March 2017 we were awarded the second and third delivery orders for engineering services in the amount of $11.5 million which will be funded incrementally and facilitate the engineering and technical support for the ADEPT program during the next three years. The third delivery order contract for $0.6 million is to provide sustainment services, such as calibration, repair, evaluations, and screenings of ADEPT units to be performed in our Manufacturing and Depot (M&D) Center in Largo, Florida.

In April 2017 we received contract awards totaling $2.0 million from the U.S. Navy to extend the capabilities of the ADSSS Condition-Based Maintenance (CBM) system to support a fourth Navy radar system, the MK 99. The Small Business Innovation Research (SBIR) office in Dahlgren, VA provided $0.5 million of the total funding to support this effort. Along with those awards, we received the fourth delivery order for $0.1 million under the existing ADEPT IDIQ contract, to provide training of the ADEPT maintenance automation workstation to sailors in the fleet.

In July 2017 we received a modification which added funding to our ADEPT IDIQ Contract, Delivery Order 02, for Engineering Services in the amount of $0.4 million. This contract award will allow us to continue support of the ADEPT product line in the fleet, implement necessary software enhancements, and general support of the program.

Key Performance Indicator

As substantially all of our revenue is derived from contracts with the federal government, our key performance indicator is the dollar volume of contracts and delivery orders awarded to us under our IDIQ contracts. Increases in the number and value of contracts awarded will generally result in increased revenues in future periods and, assuming relatively stable variable costs associated with our fulfilling such awards, increased profits in future periods. The timing of such awards is uncertain as we sell to federal government agencies where the process of obtaining such awards can be lengthy and at times uncertain. As the majority of our revenue in 2016, and expected revenue in 2017, is or will be from sales of ADEPT units and ADSSS systems under our IDIQ contracts, continued generation of delivery orders and our ability to expand the market and potential customer base for ADEPT units will be a key indicator of future revenue. ADEPT units must be serviced and calibrated every two years. Accordingly, as we continue to increase the installed base of ADEPT units and expand the units to other radar systems, we expect to generate future recurring maintenance and service revenue.

Outlook

Our strategy for continued growth is based on continuing expansion of our defense business, plus new initiatives to apply our advanced maintenance technology in commercial markets. With regard to the defense industry, we expect to continue expanding our technology base, backlog and revenue by continuing our active participation in the DoD SBIR program and bidding on projects that fall within our areas of expertise. These areas include electronic systems engineering and integration, radar systems engineering, combat/C4I (Command, Control, Communications, Computers & Intelligence) systems engineering, and communications engineering. We believe that we can use the technology and intellectual property developed under our various SBIR awards to develop proprietary products with broad appeal in both the government and commercial marketplace. Our state-of-the-art test equipment could be used by many commercial and governmental customers such as the FAA, radio and television stations, cell phone stations, and airlines. Second, we will continue to pursue SBIR projects with the Department of Homeland Security, the U.S. Navy, and other government agencies. Third, we believe that through our marketing of products, such as ADEPT, we will develop key relationships with prime defense contractors. Our strategy is to develop these relationships into long-term, key subcontractor roles on future major defense programs awarded to these prime contractors.

With regard to commercial markets, our Diagnostics Profiler and Prognostics Framework software offerings complement our hardware products and allow us to provide complete hardware/software solutions for advanced maintenance applications. Current customers for these systems, include major multinational corporations. We have received several repeat orders from these customers and continue to support their applications. Most recently we extended our Diagnostic Profiler software support with HP for a fifth year. We plan to provide “condition-based maintenance” systems for applications such as FAA radar surveillance and support systems, power distribution and utilities infrastructure, commercial shipping, cooling and environmental systems, and other “complex distributed systems” to commercial customers.

In 2017, our primary strategic focus is to continue as a premium provider of R&D and product development services to the defense industry, generate multiple delivery orders under our two IDIQ contracts, extend ADEPT and ADSSS to additional combat systems and ship classes, and expand our commercial business through marketing and sales of our Prognostics Framework and Diagnostic Profiler software products. We will also seek to generate incremental revenue through providing light assembly and production services to commercial customers at our manufacturing and depot center in Largo, Florida.

Over the longer term, we intend to further develop advanced maintenance technologies and implement these technologies in products for deployment in defense applications and to expand into additional commercial applications. We believe that many of our core capabilities, remote monitoring, rugged systems, predictive maintenance and communications expertise, are applicable to other industries that work with complex distributed systems, such as utilities, communications and transportation systems, and building maintenance. We are currently in discussions with certain industry participants regarding this initiative.

During recent fiscal years, the combination of spending caps, discretionary spending cuts, sequestration and further proposed reductions in defense spending has caused, and may in the future continue to cause, delays in funding certain projects. This may negatively impact our revenues and profits.

Changes to Critical Accounting Policies and Estimates

Our critical accounting policies and estimates are set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. As of June 30, 2017, there have been no changes to such critical accounting policies and estimates.

Results of Operations

Three Months Ended June 30, 2017 and 2016

We generated revenues of $1,740,863 during the three months ended June 30, 2017 compared to $978,372 during the three months ended June 30, 2016, an increase of $762,491, or 78%. The increase was due primarily to a production order for 11 ADEPT units in February 2017 and the receipt of four additional contracts for engineering services, support and repairs and calibration services amounting to $843,457.

Cost of sales consists of direct contract costs including labor, material, subcontracts, warranty expense for ADEPT units that have been delivered, travel, and other direct costs. Cost of sales for the three months ended June 30, 2017 was $621,582 compared to $349,526 for the three months ended June 30, 2016, an increase of $272,056 or 78%. The increase was due primarily to the receipt of a production order for 11 ADEPT units in February 2017 and the receipt of four additional contracts for engineering services, support and repairs and calibration services. As a percentage of revenue, cost of sales was 36% of revenues for the three months ended June 30, 2017 and 2016, respectively.

The majority of our engineering costs consist of (i) salary, wages and related fringe benefits paid to engineering employees, (ii) rent-related costs, and (iii) consulting fees paid to engineering consultants. As the nature of these costs benefit the entire organization and all research and development efforts, and their benefit cannot be identified with a specific project or contract, these engineering costs are classified as part of "engineering overhead" and included in operating expenses. Engineering costs for the three months ended June 30, 2017 were $539,412 compared to $312,849 for the three months ended June 30, 2016, an increase of $226,563, or 72%. The increase was due to significant increases in fringe benefits and engineering salaries due to the hiring of six additional employees, recruiting costs, travel and subsistence expenses, engineering consulting costs and incentive compensation.

General and administrative expenses consist primarily of salary, intellectual property, consulting fees and related costs, professional fees, business insurance, franchise tax, SEC compliance costs, travel, and unallowable expenses (representing those expenses for which the government will not reimburse us, including independent research and development (IR&D) which consists of research and development expenses unrelated to our defense contracts). General and administrative costs for the three months ended June 30, 2017 were $430,384 compared to $296,754 for the three months ended June 30, 2016, an increase of $133,630, or 45%. The increase was due primarily to increases in salaries, incentive compensation, and professional fees offset by a decrease in unallowable and bid and proposal costs.

At June 30, 2017, we estimated our annual effective tax rate for 2017 to be 49%. We recognized a tax expense of $73,985 for the three months ended June 30, 2017 primarily due to expected net income for the remainder of 2017. At June 30, 2017, the difference from the expected federal income tax rate is attributable to state income taxes and certain permanent book-tax differences.

Six Months Ended June 30, 2017 and 2016

We generated revenues of $3,495,836 during the six months ended June 30, 2017 compared to $1,966,301 during the six months ended June 30, 2016, an increase of $1,529,535, or 78%. The increase was due primarily to a production order for 11 ADEPT units in February 2017 and the receipt of ten additional contracts for engineering services, support and repairs and calibration services amounting to $1,488,131.

Cost of sales for the six months ended June 30, 2017 was $1,273,118 compared to $673,854 for the six months ended June 30, 2016, an increase of $599,264 or 89%. The increase was due primarily to the receipt of a production order for 11 ADEPT units in February 2017 and the receipt of ten additional contracts for engineering services, support and repairs and calibration services. As a percentage of revenue, cost of sales was 36% for the six months ended June 30, 2017 as compared to 34% of revenues for the six months ended June 30, 2016. The increase is due to an increase in production costs and other direct costs.

Engineering costs for the six months ended June 30, 2017 were $1,056,592 compared to $636,762 for the six months ended June 30, 2016, an increase of $419,830, or 66%. The increase was due to significant increases in fringe benefits and engineering salaries due to the hiring of six additional employees, recruiting costs, travel and subsistence expenses, engineering consulting costs and incentive compensation.

General and administrative costs for the six months ended June 30, 2017 were $839,287 compared to $632,902 for the six months ended June 30, 2016, an increase of $206,385, or 33%. The increase was due primarily to increases in salaries, incentive compensation, and professional fees offset by a decrease in unallowable and bid and proposal costs.

At June 30, 2017, we estimated our annual effective tax rate for 2017 to be 49%. We recognized a tax expense of $161,760 for the six months ended June 30, 2017 primarily due to expected net income for the remainder of 2017. At June 30, 2017, the difference from the expected federal income tax rate is attributable to state income taxes and certain permanent book-tax differences.

Liquidity and Capital Resources

Since our inception, we have financed our operations through debt, private and public offerings of equity securities, and cash generated by operations.

During the six months ended June 30, 2017, net cash provided by operations was $188,986 compared to net cash used in operations of $667,117 during the six months ended June 30, 2016. The increase was primarily due an increase in net income of $156,699 and the timing of receipts and payments related to our operating assets and liabilities.

We currently do not have any outstanding loan or line of credit with any bank or financial institution. We believe our available cash resources and expected cash flows from operations will be sufficient to fund operations for the next twelve months. We do not expect to incur any material capital expenditures during the next twelve months.

In order to pursue strategic opportunities, obtain additional SBIR contracts, or acquire strategic assets or businesses, we may need to obtain additional financing or seek strategic alliances or other partnership agreements with other entities. In order to raise any such financing, we anticipate considering the sale of additional debt or equity securities under appropriate market conditions. There can be no assurance, assuming we successfully raise additional funds or enter into business alliances, that we will remain profitable or continue to generate positive cash flow.

Off-Balance Sheet Arrangements

As of June 30, 2017, we did not have any relationships with unconsolidated entities or financial partners, such as entities often referred to as structured finance or special purpose entities, established for the purpose of facilitating off- balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Item 4. Controls and Procedures.

An evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934) was carried out by us under the supervision and with the participation of our president, who serves as our principal executive officer and principal financial officer. Based upon that evaluation, our president concluded that as of June 30, 2017, our disclosure controls and procedures were effective to ensure (i) that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and (ii) that such information is accumulated and communicated to management, including our president, in order to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) or 15d- 15(f)) that occurred during the fiscal quarter ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. Exhibits

No. Description

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

During the quarter ended June 30, 2017, we issued 40,000 shares of common stock to an officer upon exercise of options in consideration of cash payment of $8,000. The forgoing shares were issued pursuant to the exemption from registration provided by Section 4(a)(2) of the Securities Act of 1933, as amended.

During the quarter ended June 30, 2017, we issued 30,000 shares of restricted common stock to a new employee which vest in equal installments over a five year period. The forgoing shares were issued pursuant to the exemption from registration provided by Section 4(a)(2) of the Securities Act of 1933, as amended.

Item 6. Exhibits

No.	Description
3.1	Amendment to the By-laws of Mikros Systems Corporation (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on July 28, 2017)
10.1	Mikros Systems Corporation 2017 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on July 28, 2017)
10.2	Form of Restricted Stock Award Agreement under the Mikros Systems Corporation 2017 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed with the SEC on July 28, 2017)
10.3	Form of Stock Option Agreement under the Mikros Systems Corporation 2017 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed with the SEC on July 28, 2017)
31.1	Certification of principal executive officer and principal financial officer pursuant to Rules 13a-14(a) or 15d- 14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
32.1	Certification of principal executive officer and principal financial officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
101.INS	XBRL Instance
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation
101.DEF	XBRL Taxonomy Extension Definition
101.LAB	XBRL Taxonomy Extension Labels
101.PRE	XBRL Taxonomy Extension Presentation

SIGNATURES

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

MIKROS SYSTEMS CORPORATION

August 14, 2017

By: /s/ Thomas J. Meaney

Thomas J. Meaney
President and Chief Financial Officer

Exhibit 31.1

CERTIFICATION

I, Thomas J. Meaney, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mikros Systems Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. As the registrant's sole certifying officer, I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined in Exchange Act Rules 13(a)-15(f) and 15(d)-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report my conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. As the registrant's sole certifying officer, I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

August 14, 2017

/s/ Thomas J. Meaney
Thomas J. Meaney
President and Chief Financial Officer

Exhibit 32.1

Certifications Pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002
(18 U.S.C. Section 1350)

In connection with the Quarterly Report (the “report”) of Mikros Systems Corporation (the “Company”) on Form 10-Q for the period ended June 30, 2017, as filed with the Securities and Exchange Commission, I, Thomas J. Meaney, President and Chief Financial Officer of the Company, do hereby certify, pursuant to Section 906 of the Sarbanes- Oxley Act of 2002 (18 U.S.C. § 1350), that to my knowledge:

(1) the report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the Company.

August 14, 2017

By: /s/ Thomas J. Meaney
Thomas J. Meaney
President and Chief Financial Officer