

IPARTY CORP
Form 10-Q
November 09, 2009

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 26, 2009

OR

TRANSITION REPORT PURSUANT SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _____ to _____

Commission File Number 1-15611

iPARTY CORP.

(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| Delaware (State or Other Jurisdiction of Incorporation or Organization) | 76-0547750 (I.R.S. Employer Identification No.) |
|---|---|

| | |
|--|---------------------|
| 270 Bridge Street, Suite 301, Dedham, Massachusetts (Address of Principal Executive Offices) | 02026 (Zip Code) |
|--|---------------------|

(781) 329-3952
(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 preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting

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company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of November 4, 2009, there were 22,731,667 shares of common stock, \$.001 par value, outstanding.

iPARTY CORP.
QUARTERLY REPORT ON FORM 10-Q
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

iPARTY CORP.
CONSOLIDATED BALANCE SHEETS (unaudited)

Sep 26, 2009 Dec 27, 2008

ASSETS

| | | |
|-----------------------------------|--------------|--------------|
| Current assets: | | |
| Cash and cash equivalents | \$64,350 | \$60,250 |
| Restricted cash | 512,641 | 775,357 |
| Accounts receivable | 1,012,979 | 730,392 |
| Inventories, net | 18,377,554 | 13,022,142 |
| Prepaid expenses and other assets | 445,156 | 279,185 |
| Total current assets | 20,412,680 | 14,867,326 |
| Property and equipment, net | 3,008,388 | 3,646,481 |
| Intangible assets, net | 1,780,862 | 2,303,692 |
| Other assets | 371,082 | 177,774 |
| Total assets | \$25,573,012 | \$20,995,273 |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | | |
|--|--------------|-------------|
| Current liabilities: | | |
| Accounts payable and book overdrafts | \$10,838,220 | \$4,048,833 |
| Accrued expenses | 2,403,546 | 2,495,955 |
| Current portion of capital lease obligations | 9,228 | 6,444 |
| Current notes payable | 600,000 | 2,876,182 |
| Borrowings under line of credit | 4,741,878 | 1,950,019 |
| Total current liabilities | 18,592,872 | 11,377,433 |

Long-term liabilities:

| | | |
|---|-----------|-----------|
| Capital lease obligations, net of current portion | 16,148 | - |
| Notes payable | - | 600,000 |
| Other liabilities | 1,469,377 | 1,200,174 |
| Total long-term liabilities | 1,485,525 | 1,800,174 |

Commitments and contingencies

Stockholders' equity:

| | | |
|---|-----------|-----------|
| Convertible preferred stock - \$.001 par value; 10,000,000 shares authorized, Series B convertible preferred stock - 1,150,000 shares authorized; 464,173 shares issued and outstanding (aggregate liquidation value of \$9,283,460 at September 26, 2009) | 6,906,894 | 6,890,723 |
| Series C convertible preferred stock - 100,000 shares authorized, issued and outstanding (aggregate liquidation value of \$2,000,000 at September 26, 2009) | 1,492,000 | 1,492,000 |
| Series D convertible preferred stock - 250,000 shares authorized, issued and outstanding (aggregate liquidation value of \$5,000,000 at September 26, 2009) | 3,652,500 | 3,652,500 |

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| | | |
|--|--------------|--------------|
| Series E convertible preferred stock - 533,333 shares authorized; 296,666 shares issued and outstanding (aggregate liquidation value of \$1,112,497 at September 26, 2009) | 1,112,497 | 1,112,497 |
| Series F convertible preferred stock - 114,286 shares authorized, issued and outstanding (aggregate liquidation value of \$500,000 at September 26, 2009) | 500,000 | 500,000 |
| Total convertible preferred stock | 13,663,891 | 13,647,720 |
| Common stock - \$.001 par value; 150,000,000 shares authorized; 22,731,667 shares issued and outstanding at September 26, 2009 and December 27, 2008 | 22,732 | 22,732 |
| Additional paid-in capital | 52,199,874 | 52,095,711 |
| Accumulated deficit | (60,391,882) | (57,948,497) |
| Total stockholders' equity | 5,494,615 | 7,817,666 |
| Total liabilities and stockholders' equity | \$25,573,012 | \$20,995,273 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

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iPARTY CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

| | For the three months ended | | For the nine months ended | |
|---|----------------------------|-----------------|---------------------------|-----------------|
| | Sep 26, 2009 | Sep 27, 2008 | Sep 26, 2009 | Sep 27, 2008 |
| Revenues | \$ 16,404,046 | \$ 17,742,315 | \$ 50,541,462 | \$ 53,990,071 |
| Operating costs: | | | | |
| Cost of products sold and occupancy costs | 10,282,326 | 10,629,144 | 31,356,342 | 32,225,078 |
| Marketing and sales | 5,810,227 | 6,677,703 | 16,231,004 | 18,703,915 |
| General and administrative | 1,582,751 | 1,580,277 | 5,006,742 | 5,490,076 |
| Operating loss | (1,271,258) | (1,144,809) | (2,052,626) | (2,428,998) |
| Interest income | 45 | 240 | 90 | 2,160 |
| Interest expense | (125,769) | (178,061) | (390,849) | (576,714) |
| Net loss | \$(1,396,982) | \$(1,322,630) | \$(2,443,385) | \$(3,003,552) |
| Loss per share: | | | | |
| Basic and diluted | \$(0.06) | \$(0.06) | \$(0.11) | \$(0.13) |
| Weighted-average shares outstanding: | | | | |
| Basic and diluted | 22,731,667 | 22,730,295 | 22,731,667 | 22,719,425 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

iPARTY CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

| | For the nine months ended | |
|---|---------------------------|-----------------|
| | Sep 26, 2009 | Sep 27, 2008 |
| Operating activities: | | |
| Net loss | \$(2,443,385) | \$(3,003,552) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,571,640 | 1,522,738 |
| Deferred rent | 20,887 | 57,090 |
| Non-cash stock-based compensation expense | 118,765 | 119,153 |
| Loss on disposal of property and equipment | 1,430 | - |
| Non cash warrant expense | 137,936 | 160,644 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (34,271) | (2,920) |
| Inventories | (5,355,412) | (3,751,939) |
| Prepaid expenses and other assets | (393,712) | (33,050) |
| Accounts payable | 6,789,387 | 5,223,443 |
| Accrued expenses and other liabilities | (92,409) | 164,662 |
| Net cash provided by operating activities | 320,856 | 456,269 |
| Investing activities: | | |
| Acquisition of retail stores and non-compete agreement | - | (1,350,000) |
| Purchase of property and equipment | (347,724) | (643,878) |
| Net cash used in investing activities | (347,724) | (1,993,878) |
| Financing activities: | | |
| Net borrowings under line of credit | 2,791,859 | 1,707,203 |
| Principal payments on notes payable | (3,012,549) | (459,206) |
| Decrease in restricted cash | 262,716 | 305,575 |
| Principal payments on capital lease obligations | (11,058) | (24,932) |
| Net cash provided in financing activities | 30,968 | 1,528,640 |
| Net increase (decrease) in cash and cash equivalents | 4,100 | (8,969) |
| Cash and cash equivalents, beginning of period | 60,250 | 71,532 |
| Cash and cash equivalents, end of period | \$64,350 | \$62,563 |
| Supplemental disclosure of non-cash financing activities: | | |
| Conversion of Series B convertible preferred stock to common stock | \$- | \$34,447 |
| Acquisition of equipment under capital lease | \$29,990 | \$- |

| | | |
|------------------------------------|----------|-----|
| Disposal of property and equipment | \$28,168 | \$- |
|------------------------------------|----------|-----|

The accompanying notes are an integral part of these Consolidated Financial Statements.

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iPARTY CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 26, 2009
(Unaudited)

1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES:

Interim Financial Information

The interim consolidated financial statements as of September 26, 2009 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the consolidated balance sheets, consolidated operating results, and consolidated cash flows for the periods presented in accordance with U.S. generally accepted accounting principles. The consolidated balance sheet at December 27, 2008 has been derived from the audited consolidated financial statements at that date. Operating results for the Company on a quarterly basis may not be indicative of the results for the entire year due, in part, to the seasonality of the party goods industry. Historically, higher revenues and operating income have been experienced in the second and fourth fiscal quarters, while the Company has generated losses in the first and third quarters. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, and accompanying notes, included in the Company's Annual Report on Form 10-K, for the year ended December 27, 2008.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary after elimination of all significant intercompany transactions and balances.

Revenue Recognition

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale. The Company estimates returns based upon historical return rates and such amounts have not been significant to date.

Concentrations

The Company purchases its inventory from a diverse group of vendors. Six suppliers account for approximately 48% of the Company's purchases of merchandise for the nine months ended September 26, 2009, but the Company does not believe that it is overly dependent upon any single source for its merchandise, often using more than one vendor for similar kinds of products. The Company entered into a Supply Agreement with its largest supplier on August 7, 2006. Beginning with calendar year 2008, the Supply Agreement requires the Company to purchase on an annual basis merchandise equal to the total number of stores open during such calendar year, multiplied by \$180,000. The Supply Agreement provides for penalties in the event the Company fails to attain the annual purchase commitment that would require the Company to pay the difference between the purchases for that year and the annual purchase commitment for that year. Under the terms of the Supply Agreement, the annual purchase commitment for any individual year can be reduced for orders placed by the Company but not filled within a specified time period by the supplier. During 2008, the supplier experienced difficulty in filling completely certain orders sourced out of China. Accordingly, the supplier agreed to reduce the Company's purchase commitment for 2008 to 90% of the contractual minimum for that

year. The Company met the contractual minimum purchase requirement, as amended, for 2008. The Company believes that its purchases for 2009 will fall short of the annual commitment by approximately \$500,000. The supplier has agreed to allow the Company to roll over of any shortfall for the year 2009 into future years' requirements. The Company is not aware of any reason that would prevent it from meeting the minimum purchase requirements, including any 2009 shortfall, during the remainder of the term of the Supply Agreement.

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Accounts receivable primarily represent amounts due from credit card companies and vendors for inventory rebates. Management does not provide for doubtful accounts as such amounts have not been significant to date; the Company does not require collateral to secure the payment obligations for these accounts.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 these estimates.

Cash and Cash Equivalents and Restricted Cash

The Company considers all highly liquid investments with an original maturity date of three months or less to be cash equivalents. Cash equivalents consist primarily of store cash funds and daily store receipts in transit to our concentration bank and are carried at cost, which approximates market value.

The Company uses controlled disbursement banking arrangements as part of its cash management program. Outstanding checks, which were included in accounts payable and book overdrafts, totaled \$1,119,612 at September 26, 2009 and \$194,381 at December 27, 2008. The increase in outstanding checks as of September 26, 2009 is due to the timing of payments made in September 2009, principally related to occupancy costs, compared to the timing of payments made in December 2008.

Restricted cash represents funds on deposit established for the benefit of and under the control of Wells Fargo Retail Finance, LLC ("Wells Fargo"), the Company's lender under its line of credit, and constitutes collateral for amounts outstanding under the Company's line of credit.

Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term nature of these instruments. The fair value of borrowings under the Company's line of credit approximates carrying value because the debt bears interest at a variable market rate. The fair value of the notes payable approximates the carrying value based on their short term maturity. The fair value of the warrants issued in 2006 was determined by using the Black-Scholes model (volatility of 108%, interest of 4.73% and expected life of five years). The fair value of the warrants issued in 2008 was also determined by using the Black-Scholes model (volatility of 101%, risk free rate of 2.36% and expected life of five years).

As permitted by ASC 820-10-65-1, Effective Date of ASC 820, "Fair Value Measurements and Disclosures", the Company elected to defer the adoption of ASC 820 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, until December 28, 2008. The adoption of ASC 820-10-65-1 in fiscal 2009 has not had a material impact on the Company's financial position, results of operations or cash flows.

Inventories

Inventories consist of party supplies and are valued at the lower of moving weighted-average cost or market. Inventory has been reduced by an allowance for obsolete and excess inventory, which is based on management's review of inventories on hand compared to estimated future sales. The Company records vendor rebates, discounts and certain other adjustments to inventory, including freight costs, and these amounts are recognized in the income statement as the related goods are sold.

The activity in the allowance for obsolete and excess inventory is as follows:

| | Nine months ended Sep 26, 2009 | Twelve months ended Dec 27, 2008 |
|----------------------------|-----------------------------------|-------------------------------------|
| Beginning balance | \$ 942,587 | \$ 969,859 |
| Increases to reserve | 250,000 | 405,000 |
| Write-offs against reserve | (278,136) | (432,272) |
| Ending balance | \$ 914,451 | \$ 942,587 |

Net Loss per Share

Net loss per basic share is computed by dividing net loss available to common shareholders by the weighted-average number of common shares outstanding. The common share equivalents of Series B-F preferred stock are required to be included in the calculation of net income per basic share, since the preferred stockholders are entitled to participate in dividends when and if declared by the Board of Directors on the same basis as if the shares of Series B-F preferred stock were converted to common stock. For periods with net losses, the Company does not allocate losses to Series B-F preferred stock.

Net loss per diluted share is computed by dividing net loss by the weighted average number of common shares outstanding, plus the common share equivalents of Series B-F preferred stock on an as if-converted basis, plus the common share equivalents of the “in the money” stock options and warrants as computed by the treasury method. For the periods with net losses, the Company excludes these common share equivalents since their impact would be anti-dilutive.

As of September 26, 2009, there were 27,802,157 potential additional common share equivalents outstanding, which were not included in the calculation of diluted net loss per share for the three months and nine months then ended because their effect would be anti-dilutive. These included 15,493,478 shares upon the conversion of the Company’s Series B-F preferred stock, 2,083,334 shares upon the exercise of a warrant with an exercise price of \$0.475 per share, 100,000 shares upon the exercise of warrants with a weighted average exercise price of \$1.50 per share and 10,125,345 shares upon the exercise of stock options with a weighted average exercise price of \$0.46 per share.

Stock option compensation expense

The Company uses the Black-Scholes option pricing model to determine the fair value of stock based compensation. The Black-Scholes model requires the Company to make several subjective assumptions, including the estimated length of time employees will retain their vested stock options before exercising them (“expected term”), and the estimated volatility of the Company’s common stock price over the expected term, which is based on historical volatility of the Company’s common stock over a time period equal to the expected term. The Black-Scholes model also requires a risk-free interest rate, which is based on the U.S. Treasury yield curve in effect at the time of the grant, and the dividend yield on the Company’s common stock, which is assumed to be zero since the Company does not pay dividends and has no current plans to do so in the future. Changes in these assumptions can materially affect the estimate of fair value of stock based compensation and consequently, the related expense recognized in the consolidated statements of operations. The Company recognizes stock based compensation expense on a straight-line basis over the vesting period of each grant.

The stock based compensation expense recognized by the Company was:

| | For the three months ended | | For the nine months ended | |
|----------------------------------|----------------------------|--------------|---------------------------|--------------|
| | Sep 26, 2009 | Sep 27, 2008 | Sep 26, 2009 | Sep 27, 2008 |
| Stock Based Compensation Expense | \$41,248 | \$38,204 | \$118,765 | \$119,153 |

Stock based compensation expense is included in general and administrative expense and had no impact on cash flow from operations and cash flow from financing activities for the nine months ended September 26, 2009.

On May 27, 2009, the Company's stockholders approved a new equity incentive plan entitled the 2009 Stock Incentive Plan (the "2009 Plan"). The Company will no longer grant equity awards under its former equity incentive plan, the Amended and Restated 1998 Incentive and Nonqualified Stock Option Plan (the "1998 Plan" and with the 2009 Plan, the "Plans").

Under the Company's Plans, options to acquire shares of common stock may be granted to officers, directors, key employees and consultants. Under the 2009 Plan, the exercise price for qualified incentive options and non-qualified options cannot be less than the fair market value of the stock on the grant date, as determined by the Company's Board of Directors. In addition, under the 2009 Plan, other stock based and performance awards may be granted to officers, directors, key employees and consultants, including stock appreciation rights, restricted stock, and restricted stock units. Under the Plans, a combined total of 11,000,000 shares of common stock or other stock based awards may be granted. To date, the Company has only issued options under its Plans, which have been granted to employees, directors and consultants of the Company at fair market value at the date of grant. Generally, employee options become exercisable over periods of up to four years, and expire ten years from the date of grant.

The Company granted options for the purchase of an aggregate of 1,085,000 shares of common stock to key employees, including its executive officers, and each of the four independent members of the Board of Directors on May 27, 2009 at an exercise price of \$0.11 per share. In addition, the Company granted options for the purchase of an aggregate of 200,000 shares of common stock to its Chief Financial Officer on March 4, 2009 at an exercise price of \$0.07 per share. On June 4, 2008, the Company granted options for the purchase of an aggregate of 200,000 shares of common stock to its Chief Financial Officer and each of the four independent members of the Board of Directors at an exercise price of \$0.29 per share. The weighted-average fair market value using the Black-Scholes option pricing model of the options granted on May 27, 2009 was \$0.09 per share, was \$0.06 per share for the options granted on March 4, 2009 and was \$0.22 per share for the options granted on June 4, 2008. The fair market value of the options at the date of the grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | For the nine months ended | | | |
|---|---------------------------|---|--------------|---|
| | Sep 26, 2009 | | Sep 27, 2008 | |
| Risk-free interest rate | 2.23 | % | 3.21 | % |
| Expected volatility | 109.52 | % | 101.20 | % |
| Weighted average expected life (in years) | 6.25 | | 5.00 | |
| Expected dividends | - | | - | |

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A summary of the Company's stock options is as follows:

| | Number of Stock Options | Weighted Average Exercise Price | Weighted Average Exercise Price | Price Range | Weighted Average Remaining Life (Years) | Aggregate Intrinsic Value |
|---|----------------------------------|--|--|----------------|---|---------------------------------|
| Outstanding - December 27, 2008 | 9,082,198 | \$ 0.55 | \$ 0.13 | - | \$ 4.25 | |
| Granted | 1,285,000 | 0.10 | 0.07 | - | 0.11 | |
| Expired/Forfeited | (241,853) | 2.19 | 0.18 | - | 3.13 | |
| Exercised | - | - | - | - | - | |
| Outstanding - September 26, 2009 | 10,125,345 | \$ 0.46 | \$ 0.07 | - | \$ 4.25 | \$ 179,107 |
| Exercisable - September 26, 2009 | 8,304,399 | \$ 0.52 | \$ 0.11 | - | \$ 4.25 | \$ - |
| Available for grant - September 26, 2009 | 439,394 | | | | | |

The following table summarizes information for options outstanding and exercisable at September 26, 2009:

| Price Range | Outstanding | | | Exercisable | | |
|-------------------|----------------------------------|---|--|----------------------------------|--|--|
| | Number of Stock Options | Weighted Average Remaining Life (Years) | Weighted Average Exercise Price | Number of Stock Options | Weighted Average Exercise Price | |
| \$ 0.07 - \$ 0.20 | 1,415,350 | 8.9 | \$ 0.11 | 155,350 | \$ 0.17 | |
| 0.21 - 0.30 | 3,412,797 | 1.9 | 0.25 | 3,344,047 | 0.25 | |
| 0.31 - 0.50 | 2,434,120 | 5.6 | 0.39 | 1,941,924 | 0.38 | |
| 0.51 - 1.00 | 2,674,778 | 3.6 | 0.77 | 2,674,778 | 0.77 | |
| 1.01 - 3.50 | 88,300 | 2.1 | 2.40 | 88,300 | 2.40 | |
| 3.51 - 4.25 | 100,000 | 0.2 | 4.14 | 100,000 | 4.14 | |
| Total | 10,125,345 | 4.2 | \$ 0.46 | 8,304,399 | \$ 0.52 | |

The remaining unrecognized stock based compensation expense related to unvested awards at September 26, 2009 was \$242,248 and the period of time over which this expense will be recognized is 3.67 years.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and are depreciated on the straight-line method over the estimated useful lives of the assets. Expenditures for maintenance and repairs are charged to operations as incurred. A listing of the estimated useful life of the various categories of property and equipment is as follows:

| Asset Classification | Estimated Useful Life |
|----------------------|-----------------------|
|----------------------|-----------------------|

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| | |
|--------------------------------|-------------------------------------|
| Leasehold improvements | Lesser of term of lease or 10 years |
| Furniture and fixtures | 7 years |
| Computer hardware and software | 3 years |
| Equipment | 5 years |

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Intangible Assets

On August 15, 2007, the Company entered into an Asset Purchase Agreement to purchase two franchised Party City Corporation retail stores in Lincoln, Rhode Island and Warwick, Rhode Island, in exchange for aggregate consideration of \$1,350,000 plus up to \$400,000 for associated inventory. On January 2, 2008, the Company completed the purchase of the two stores. The aggregate consideration paid was \$1,350,000 plus approximately \$195,000 for associated inventory. Funding for the purchase was obtained from the Company's existing line of credit with Wells Fargo. The stores were converted into iParty stores immediately following the closing of the transaction.

Intangible assets consist primarily of (i) the values of two non-compete agreements acquired in conjunction with the purchase of retail stores in 2006 and 2008, and (ii) the values of retail store leases acquired in those transactions. These assets have been accounted for at fair value as of their respective acquisition dates using significant other observable inputs, or Level 2 criteria, defined in the Fair Value Measurements section below.

The first non-compete agreement, from Party City Corporation and its affiliates, covers Massachusetts, Maine, New Hampshire, Vermont, Rhode Island, and Windsor and New London counties in Connecticut, and expires in 2011. The second non-compete agreement was acquired in connection with the Company's purchase in January 2008 of the two party supply stores in Lincoln and Warwick, Rhode Island described above. It covers Rhode Island for five years from the date of closing and within a certain distance from the Company's stores in the rest of New England for three years. Both non-compete agreements have an estimated life of 60 months and are subject to certain terms and conditions in their respective acquisition agreements.

The occupancy valuations relate to acquired retail store leases for stores in Peabody, Massachusetts (estimated life of 90 months), Lincoln, Rhode Island (estimated life of 79 months) and Warwick, Rhode Island (estimated life of 96 months). Intangible assets also include legal and other transaction costs incurred related to the purchase of the Peabody, Lincoln and Warwick stores.

Intangible assets as of September 26, 2009 and December 27, 2008 were:

| | Sep 26, 2009 | Dec 27, 2008 |
|--------------------------------|---------------------|---------------------|
| Non-compete agreements | \$ 2,358,540 | \$ 2,358,540 |
| Occupancy valuations | 944,716 | 944,716 |
| Other | 157,855 | 157,855 |
| Intangible assets | 3,461,111 | 3,461,111 |
| Less: accumulated amortization | (1,680,249) | (1,157,419) |
| Intangible assets, net | \$ 1,780,862 | \$ 2,303,692 |

Amortization expense for these intangible assets was:

| | For the three months ended | | For the nine months ended | |
|----------------------|----------------------------|--------------|---------------------------|--------------|
| | Sep 26, 2009 | Sep 27, 2008 | Sep 26, 2009 | Sep 27, 2008 |
| Amortization expense | \$ 174,277 | \$ 130,427 | \$ 522,830 | \$ 445,581 |

The amortization expense for the non-compete agreements and other intangible assets is included in general and administrative expense in the Consolidated Statements of Operations. The amortization expense for occupancy valuation is included in cost of products sold and occupancy costs in the Consolidated Statements of Operations.

Future amortization expense related to these intangible assets as of September 26, 2009 is:

| Year | Amount |
|------------|--------------|
| 2009 | \$ 174,277 |
| 2010 | 672,108 |
| 2011 | 467,412 |
| 2012 | 242,438 |
| 2013 | 127,029 |
| Thereafter | 97,598 |
| Total | \$ 1,780,862 |

Accounting for the Impairment of Long-Lived Assets

The Company reviews each store for impairment indicators whenever events and changes in circumstances suggest that the carrying amounts may not be recoverable from estimated future store cash flows. The Company's review considers store operating results, future sales growth and cash flows. During the third quarter of 2007, the Company decided to close its stores in North Providence, Rhode Island and Auburn, Massachusetts at the end of their lease terms, which expired on January 31, 2008. No material impairment costs were incurred as a result of that decision. As of September 26, 2009, the Company does not believe that any of its assets are impaired.

Notes Payable

Notes payable consist of three notes entered into in fiscal 2006.

The "Highbridge Note" was a subordinated note in the stated principal amount of \$2,500,000 that bore interest at the prime rate plus one percent. The Highbridge Note was part of a financing transaction that raised \$2.5 million through a combination of the issuance of the Highbridge Note and a warrant exercisable for 2,083,334 shares of common stock at an exercise price of \$0.475 per share. The original discount associated with the warrant issued in conjunction with the Highbridge Note (original discount amount \$613,651) was amortized using the effective interest method over the life of the note. Interest only was payable quarterly in arrears during the term of the note and the entire principal balance was due at the maturity date. The note matured on September 15, 2009, at which time the Company paid the full principal amount of \$2,500,000 plus all accrued interest.

The "Amscan Note" was a subordinated promissory note in the original principal amount of \$1,819,373. The note bore interest at the rate of 11.0% per annum and was payable in thirty-six (36) equal monthly installments of principal and interest of \$59,562 beginning on November 1, 2006. The remaining principal balance and all accrued interest were paid in full on September 24, 2009.

The "Party City Note" is a subordinated promissory note in the principal amount of \$600,000. The note bears interest at the rate of 12.25% per annum and is payable by quarterly interest-only payments over four years, with the full principal amount due at the note's maturity on August 7, 2010.

On August 7, 2006, the Company entered into a Supply Agreement with Amscan Inc. ("Amscan"), the largest supplier in the party goods industry. The Supply Agreement with Amscan gives the Company the right to receive certain additional rebates and more favorable pricing terms over the term of the agreement than generally were available to the Company under its previous terms with Amscan. The right to receive additional rebates, and the amount of such rebates, are subject to the Company's achievement of increased levels of purchases and other factors provided for in the Supply Agreement. In exchange, the Supply Agreement obligates the Company to purchase increased levels of merchandise from Amscan until 2012. The Supply Agreement provided for an initial ramp-up period during 2006 and 2007 and, beginning with calendar year 2008, requires the Company to purchase on an annual basis merchandise

equal to the total number of its stores open during such calendar year, multiplied by \$180,000 until 2012. The Supply Agreement provides for penalties in the event the Company fails to attain the annual purchase commitment. Under the terms of the Supply Agreement, the annual purchase commitment for any individual year can be reduced for orders placed by the Company but not filled by the supplier within a specified time period. During 2008, the supplier experienced difficulty in filling completely certain orders sourced out of China. Accordingly, the supplier agreed to reduce the Company's purchase commitment for 2008 to 90% of the contractual minimum for that year. The Company believes that its purchases for 2009 will fall short of the annual commitment by approximately \$500,000. The supplier has agreed to allow the Company to roll over any shortfall for the year 2009 into future years' requirements. The Company is not aware of any reason that would prevent it from meeting the minimum purchase requirements, including any 2009 shortfall, for the remainder of the term of the Supply Agreement.

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The Supply Agreement also provided for Amscan to extend, until October 31, 2006, approximately \$1,150,000 of certain currently due amounts owed by the Company to Amscan which would otherwise have been payable on August 8, 2006 (the "extended payables") and gave the Company the right, at its option, to convert the extended payables into a subordinated promissory note. On October 24, 2006, the Company converted \$1,143,896 of extended payables originally due to Amscan as of August 8, 2006 as well as an additional \$675,477 of payables due to Amscan as of September 28, 2006 into a single subordinated promissory note in the total principal amount of \$1,819,373, which was the Amscan Note defined above. As noted above, the Company has paid in full the Amscan Note.

On August 7, 2006, the Company also entered into and simultaneously closed an Asset Purchase Agreement with Party City, an affiliate of Amscan, pursuant to which the Company acquired a Party City retail party goods store in Peabody, Massachusetts and received a five-year non-competition covenant from Party City, for aggregate consideration of \$2,450,000, payable by a subordinated note in the principal amount of \$600,000, which is the Party City Note defined above, and \$1,850,000 in cash.

Line of Credit

On July 1, 2009, the Company and its wholly-owned subsidiary, iParty Retail Stores Corp., as borrowers (together, the "Borrowers"), and Wells Fargo, as administrative agent, collateral agent, swing line lender and lender, entered into a Second Amended and Restated Credit Agreement (the "Agreement").

The Agreement amended and restated the previous revolving credit facility with Wells Fargo, continued the revolving line of credit with Wells Fargo in the amount of up to \$12,500,000 and extended the maturity date of the revolving line of credit for three years to July 2, 2012. In addition, the Agreement includes an option whereby the Borrowers may increase the revolving line of credit up to a maximum level of \$15,000,000, at any time until July 2, 2011. The amount of credit that is available from time to time under the Agreement is determined as a percentage of the value of eligible inventory plus a percentage of the value of eligible credit card receivables, as reduced by certain reserve amounts that may be required by Wells Fargo.

Borrowings under the Agreement will generally accrue interest at a margin ranging from 3.00% to 3.50% (determined according to the average daily excess availability during the fiscal quarter immediately preceding the adjustment date) over, at the Borrowers' election, either the London Interbank Offered Rate ("LIBOR") or a base rate determined by Wells Fargo from time to time. The credit facility also provides for letters of credit and includes an unused line fee on the unused portion of the revolving credit line.

The obligations of the Borrowers under the Agreement and the other loan documents are secured by a lien on substantially all of the personal property of the Borrowers.

The Agreement has financial covenants that are limited to minimum availability and capital expenditures and contains a number of restrictive covenants, such as incurrence, payment or entry into certain indebtedness, liens, investments, acquisitions, mergers, dispositions and dividends. The Agreement contains events of default customary for credit facilities of this type. Upon an event of default that is not cured or waived within any applicable cure periods, in addition to other remedies that may be available to Wells Fargo, the obligations under the Agreement may be accelerated, outstanding letters of credit may be required to be cash collateralized and the lenders may exercise remedies to collect the balance due, including to foreclose on the collateral. Should the Agreement be prepaid or the maturity accelerated for any reason, the Borrowers would be responsible for an early termination fee in the amount of (i) 1.50% of the revolving credit facility ceiling then in effect within the first year of the term of the facility, (ii) 1.00% of the revolving credit facility ceiling then in effect within the second year of the term of the facility and (iii) 0.50% thereafter.

Stockholders' Equity

During the nine months ended September 26, 2009, there were no exercises of stock options or warrants, and no conversions of convertible preferred stock.

On May 27, 2009, the Company's stockholders approved an amendment to the Company's Restated Certificate of Incorporation to authorize the Board of Directors to implement a reverse stock split, pursuant to which the existing shares of the Company's common stock would be combined into new shares of the Company's common stock at an exchange ratio ranging between one-for-five and one-for-thirty, with the exchange ratio to be determined by the Board of Directors (the "Reverse Stock Split"). With the approval of the Reverse Stock Split, the Board of Directors will have the authority, but not the obligation, to effect the Reverse Stock Split at any time prior to the date of the 2010 Annual Meeting of Stockholders, without further approval or authorization of stockholders. The Reverse Stock Split will be effected, if at all, only upon a determination by the Board of Directors that implementing a Reverse Stock Split is in the best interest of the Company and its stockholders and after the filing of an amendment to the Company's Restated Certificate of Incorporation with the Secretary of State of the State of Delaware.

Fair Value Measurements

Effective December 30, 2007, the Company adopted Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures. ASC 820 defined fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also described three levels of inputs that may be used to measure the fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities

Level 2 – observable inputs other than quoted prices in active markets for identical assets or liabilities

Level 3 – unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions

The only assets and liabilities subject to fair value measurement standards at September 26, 2009 and December 27, 2008 are cash equivalents and restricted cash which are based on Level 1 inputs.

2. SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the time of the filing of this Quarterly Report on Form 10-Q with the SEC on November 9, 2009 and has determined that there were no subsequent events to recognize or disclose in these financial statements.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the unaudited Consolidated Financial Statements and related Notes included in Item 1 of this Quarterly Report on Form 10-Q and the audited Consolidated Financial Statements and related Notes and Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, contained in our Annual Report on Form 10-K for the fiscal year ended December 27, 2008.

Certain statements in this Quarterly Report on Form 10-Q, particularly statements contained in this Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words “anticipate”, “believe”, “estimate”, “expect”, “plan”, “intend” and other similar expressions are intended to identify these forward-looking statements, but are not the exclusive means of identifying them. Forward-looking statements included in this Quarterly Report on Form 10-Q or hereafter included in other publicly available documents filed with the Securities and Exchange Commission (“SEC”), reports to our stockholders and other publicly available statements issued or released by us involve known and unknown risks, uncertainties, and other factors which could cause our actual results, performance (financial or operating) or achievements to differ from the future results, performance (financial or operating) or achievements expressed or implied by such forward looking statements. Such future results are based upon our best estimates based upon current conditions and the most recent results of operations. Various risks, uncertainties and contingencies could cause our actual results, performance or achievements to differ materially from those expressed in, or implied by, the forward-looking statements contained in this Quarterly Report on Form 10-Q. These include, but are not limited to, those described below under the heading “Factors That May Affect Future Results” and in Part II, Item 1A, “Risk Factors” as well as under Item 1A, “Risk Factors” of our most recently filed Annual Report on Form 10-K for the year ended December 27, 2008 and our other periodic reports filed with the SEC. We assume no obligation to update these forward looking statements contained in this report, whether as a result of new information, future events or otherwise.

Overview

We are a leading brand in the party industry in the markets we serve and a leading resource in those markets for consumers seeking party goods, party planning advice and relevant information. We are a party goods retailer operating stores throughout New England, where 45 of our 50 retail stores are located. We also license the name “iparty.com” (at www.iparty.com) to a third party in exchange for royalties, which to date have not been significant.

Our 50 retail stores are located predominantly in New England with 25 stores in Massachusetts, 7 in Connecticut, 6 in New Hampshire, 3 in Rhode Island, 3 in Maine and 1 in Vermont. We also operate 5 stores in Florida. Our stores range in size from approximately 8,000 square feet to 20,500 square feet and average approximately 10,300 square feet in size. We lease our properties, typically for 10 years and usually with options from our landlords to renew our leases for an additional 5 or 10 years.

The following table shows the number of stores in operation (not including temporary stores):

| | For the nine months ended | |
|-------------------------|---------------------------|-----------------|
| | Sep 26, 2009 | Sep 27, 2008 |
| Beginning of period | 50 | 50 |
| Openings / Acquisitions | - | 2 |
| Closings | - | (2) |
| End of period | 50 | 50 |

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Our stores feature over 20,000 products ranging from paper party goods, Halloween costumes, greeting cards and balloons to more unique merchandise such as piñatas, tiny toys, masquerade and Hawaiian Luau items. Our sales are driven by the following holiday and party events: Halloween, Christmas, Easter, Valentine's Day, New Year's, Independence Day, St. Patrick's Day, Thanksgiving, Hanukkah and professional sports playoff events. We also focus our business closely on lifetime events such as anniversaries, graduations, birthdays, and bridal or baby showers.

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In addition to the stores discussed in the paragraphs above, we opened two temporary Halloween stores in the greater Boston area in September 2008. Those stores were closed in early November 2008. In September 2009, we opened four temporary Halloween stores. Three of the stores were in the greater Boston area and one of the stores was in New Hampshire. These stores feature a strategically selected assortment of Halloween related merchandise and were closed in early November 2009.

Trends and Quarterly Summary

Third Quarter Summary

Our business has a seasonal pattern. In the past three years, we have realized approximately 34.7% of our annual revenues in our fourth quarter, which includes Halloween and Christmas, and approximately 24.5% of our revenues in the second quarter, which includes school graduations and usually includes Easter. Also, during the past three years, we have had net income in our second and fourth quarters and generated losses in our first and third quarters.

For the third quarter of 2009, our consolidated revenues were \$16.4 million, compared to \$17.7 million for the third quarter of 2008. The decrease in third quarter revenues from the year-ago period included a 7.7% decrease in comparable store sales. The decrease in consolidated revenue was primarily due to a decrease in customer traffic and an increase in promotional markdowns, both of which are related to the effects of the recession in the U.S. and world economies. Consolidated gross profit margin was 37.3% for the third quarter of 2009 compared to a margin of 40.1% for the same period in 2008. The decline in gross profit margin was substantially due to increases in occupancy costs as well as the decreased leveraging of those costs related to lower sales. The consolidated net loss for the third quarter of 2009 was \$1,396,982 or \$0.06 per share, compared to a consolidated net loss of \$1,322,630, or \$0.06 per share, for the third quarter in 2008, an increase of \$74,352. We have mitigated the decline in revenues year over year primarily through the cost cutting initiatives we undertook at the end of 2008, resulting in a flat net loss in the third quarter of 2009 compared to the third quarter of 2008.

October Summary

On November 4, 2009, we reported sales results for the calendar month and year, and for the fiscal month and year, ended October, 2009, to provide information regarding our Halloween season which is our most important selling season. For the thirty-one day calendar month of October 2009, sales at comparable stores increased 0.1% compared to the same period in 2008. Consolidated revenues for the calendar month were approximately \$18.42 million, a 5.4% increase compared to \$17.48 million for the same period in 2008. For the five week fiscal month of October, which ended on October 31st, sales at comparable stores decreased 1.8% compared to fiscal October 2008. Consolidated revenues increased by 3.3% for the October fiscal month compared to the same fiscal month period in 2008. The increase in consolidated revenues for the calendar and fiscal months of October 2009 included the impact of four temporary Halloween stores opened in mid-September 2009, compared to two such stores opened in mid-September 2008.

For the calendar year 2009 through October, sales at comparable stores decreased 5.4% compared to the same period in 2008. Consolidated revenues were approximately \$68.31 million, a 4.1% decrease compared to \$71.20 million for the same period in 2008. For the forty-four week period through fiscal October 2009, which ended on October 31st, sales at comparable stores decreased 5.3% compared to the same period in 2008. Consolidated revenues decreased by 3.9% for the fiscal year-to-date period through October compared to the same period in 2008. The decrease in consolidated revenues for the calendar and fiscal year-to-date periods through October included the impact of four temporary Halloween stores opened in mid-September 2009, compared to two such stores opened in mid-September 2008.

Acquisition and Growth Strategy

We operate in a largely un-branded market that has many small businesses. As a result, we have considered, and may continue to consider, growing our business through acquisitions of other entities or through opening new iParty stores. Any determination to make an acquisition or open a new store will be based upon a variety of factors, including, without limitation, the purchase price and other financial terms of the acquisition, the business prospects and geographical location of the potential acquisition or store opening, and the extent to which any acquisition or store opening would enhance our prospects. Given the current state of the economy and our focus on maintaining liquidity, we do not expect to acquire or open any new stores in the remainder of 2009, except for the temporary Halloween stores, and we are currently reviewing our strategy with respect to 2010. However, in view of the operating results from the four temporary Halloween stores opened in 2009, we currently expect to open additional temporary Halloween stores in 2010.

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On January 2, 2008, we completed the purchase of two stores in Rhode Island. The aggregate consideration paid was \$1,350,000 plus approximately \$195,000 for associated inventory. Funding for the purchase was obtained from our line of credit with Wells Fargo Retail Finance, LLC (“Wells Fargo”). The stores were converted into iParty stores immediately following the closing of the transaction. The consideration paid for the assets acquired in the transaction was allocated based upon an independent appraisal to the following, based on their fair values on the date of purchase:

| | Fair Value at Jan 2, 2008 |
|-----------------------|------------------------------|
| Non-compete agreement | \$ 781,000 |
| Occupancy valuation | 495,000 |
| Equipment and other | 74,000 |
| | \$ 1,350,000 |

Results of Operations

Fiscal year 2009 has 52 weeks and ends on December 26, 2009. Fiscal year 2008 had 52 weeks and ended on December 27, 2008.

The third quarter of fiscal year 2009 had 13 weeks and ended on September 26, 2009. The third quarter of fiscal year 2008 had 13 weeks and ended on September 27, 2008.

Expense Management Actions for Fiscal 2009

In 2008, the US economy entered into a recessionary period combined with a systematic lack of financial liquidity. During that year, the housing crisis deepened, the stock market declined dramatically, and unemployment rose steeply. All of these factors contributed to a difficult retail environment. Many economists anticipated a difficult 2009. Although we fared better than many of our competitors in 2008, we have taken significant steps in response to the economic crisis. We reviewed and revamped our headquarters and store expenses, which included reducing our headcount and decreasing our advertising and other administrative costs. We expect to save up to \$3 million through reduced operating expenses in 2009 from these actions. We continue to monitor sales performance, customer buying patterns and consumer confidence, and we are prepared to make further adjustments to our cost structure as needed to manage our way through this recession.

Three Months Ended September 26, 2009 Compared to Three Months Ended September 27, 2008

Revenues

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale. Our consolidated revenues for the third quarter of fiscal 2009 were \$16,404,046, a decrease of \$1,338,269, or 7.5% from the third quarter of the prior fiscal year. The decline was primarily due to the decreased level of consumer demand and increased level of promotional markdowns, both of which are related to the U.S. recession.

| | For the three months ended | |
|----------------------|----------------------------|---------------|
| | Sep 26, 2009 | Sep 27, 2008 |
| Revenues | \$ 16,404,046 | \$ 17,742,315 |
| Decrease in revenues | -7.5 | % |
| | -2.6 | % |

Comparable store sales for the quarter decreased by 7.7%.

Cost of products sold and occupancy costs

Cost of products sold and occupancy costs consist of the cost of merchandise sold to customers and the occupancy costs for our stores. Our cost of products sold and occupancy costs for the third quarter of fiscal 2009 were \$10,282,326, or 62.7% of revenues, a decrease of \$346,818 and an increase of 2.8 percentage points, as a percentage of revenues, from the third quarter of the prior fiscal year.

| | For the three months ended | | | |
|---|----------------------------|------------|--------------|------------|
| | Sep 26, 2009 | | Sep 27, 2008 | |
| Cost of products sold and occupancy costs | \$ | 10,282,326 | \$ | 10,629,144 |
| Percentage of revenues | | 62.7 | % | 59.9 |
| | | | | % |

As a percentage of revenues, the increase in cost of products sold and occupancy costs was primarily attributable to increased occupancy costs and the decreased leveraging of these occupancy costs related to lower sales in the third quarter of 2009 compared to the third quarter of 2008.

Marketing and sales expense

Marketing and sales expense consists primarily of advertising and promotional expenditures, all store payroll and related expenses for personnel engaged in marketing and selling activities and other non-payroll expenses associated with operating our stores. Our consolidated marketing and sales expense for the third quarter of fiscal 2009 was \$5,810,227, or 35.4% of revenues, a decrease of \$867,476 or 2.2 percentage points, as a percentage of revenues, from the third quarter of the prior fiscal year.

| | For the three months ended | | | |
|------------------------|----------------------------|-----------|--------------|-----------|
| | Sep 26, 2009 | | Sep 27, 2008 | |
| Marketing and sales | \$ | 5,810,227 | \$ | 6,677,703 |
| Percentage of revenues | | 35.4 | % | 37.6 |
| | | | | % |

As a percentage of revenues, the decrease in marketing and sales expense was primarily the result of our cost reduction actions related to store payroll and advertising expenses, as described above.

General and administrative expense

General and administrative (“G&A”) expense consists of payroll and related expenses for executive, merchandising, finance and administrative personnel, as well as information technology, professional fees and other general corporate expenses. Our consolidated G&A expense for the third quarter of fiscal 2009 was \$1,582,751, or 9.6% of revenues, an increase of \$2,474 or 0.7 percentage points, as a percentage of revenues, from the third quarter of the prior fiscal year.

| | For the three months ended | | | |
|----------------------------|----------------------------|-----------|--------------|-----------|
| | Sep 26, 2009 | | Sep 27, 2008 | |
| General and administrative | \$ | 1,582,751 | \$ | 1,580,277 |
| Percentage of revenues | | 9.6 | % | 8.9 |
| | | | | % |

The flat level of general and administrative expense in the third quarter of 2009 compared to the third quarter of the prior fiscal year was the result of offsetting factors. Expense savings in 2009 related to reduced payroll and other costs were offset by the absence in the third quarter of 2009 of an expense reversal included in the third quarter of 2008 related to the cancellation of 2008 management bonuses.

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The increase in general and administrative expense as a percentage of revenues from the third quarter of the prior fiscal year was due to the decreased leveraging of these costs related to lower sales in the third quarter of 2009 compared to the third quarter of 2008.

Operating income

Our operating loss for the third quarter of fiscal 2009 was \$1,271,258, or 7.7% of revenues, compared to an operating loss of \$1,144,809, or 6.5% of revenues for the third quarter of the prior fiscal year.

Interest expense

Our interest expense in the third quarter of fiscal 2009 was \$125,769, a decrease of \$52,292 from the third quarter of the prior fiscal year. The decrease in the third quarter of fiscal 2009 was primarily due to a lower effective rate on our Highbridge Note which was paid in full on September 15, 2009 and lower interest expense on our Amscan Note due to principal amortization of that indebtedness, which was paid in full on September 24, 2009.

Income taxes

We have not provided for income taxes for the third quarter of fiscal 2009 or fiscal 2008 due to losses in the nine month period ended September 26, 2009 and for fiscal 2008 and the availability of net operating loss (NOL) carryforwards to eliminate federal taxable income on an annual basis. No benefit has been recognized with respect to current losses or NOL carryforwards due to the uncertainty of future taxable income.

At the end of fiscal 2008, we had estimated federal net operating loss carryforwards of approximately \$20.3 million, which begin to expire in 2019. In accordance with Section 382 of the Internal Revenue Code of 1986, as amended, the use of these carryforwards will be subject to annual limitations based upon certain ownership changes of our stock that have occurred or that may occur.

Net loss

Our net loss in the third quarter of fiscal 2009 was \$1,396,982, or \$0.06 per basic and diluted share, compared to a net loss of \$1,322,630, or \$0.06 per basic and diluted share, in the third quarter of the prior fiscal year.

Nine Months Ended September 26, 2009 Compared to Nine Months Ended September 27, 2008

Revenues

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale. Our consolidated revenues for the first nine months of fiscal 2009 were \$50,541,462, a decrease of \$3,448,609 or 6.4% from the first nine months of the prior fiscal year.

| | For the nine months ended | |
|----------------------|---------------------------|---------------|
| | Sep 26, 2009 | Sep 27, 2008 |
| Revenues | \$ 50,541,462 | \$ 53,990,071 |
| Decrease in revenues | -6.4 | % -0.4 |

Comparable store sales for the first nine months decreased by 6.5%.

Cost of products sold and occupancy costs

Cost of products sold and occupancy costs consist of the cost of merchandise sold to customers and the occupancy costs for our stores. Our cost of products sold and occupancy costs for the first nine months of fiscal 2009 were \$31,356,342, or 62.0% of revenues, a decrease of \$868,736 and an increase of 2.3 percentage points, as a percentage of revenues, from the first nine months of the prior fiscal year.

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| | For the nine months ended | | | |
|---|---------------------------|---------------|---|---|
| | Sep 26, 2009 | Sep 27, 2008 | | |
| Cost of products sold and occupancy costs | \$ 31,356,342 | \$ 32,225,078 | | |
| Percentage of revenues | 62.0 | 59.7 | % | % |

As a percentage of revenues, the increase in cost of products sold and occupancy costs was primarily attributable to increased occupancy costs and the decreased leveraging of these occupancy costs related to lower sales in the first nine months of 2009 compared to the first nine months of the prior fiscal year.

Marketing and sales expense

Marketing and sales expense consists primarily of advertising and promotional expenditures, all store payroll and related expenses for personnel engaged in marketing and selling activities and other non-payroll expenses associated with operating our stores. Our consolidated marketing and sales expense for the first nine months of fiscal 2009 was \$16,231,004, or 32.1% of revenues, a decrease of \$2,472,911 or 2.5 percentage points, as a percentage of revenues, from the first nine months of the prior fiscal year.

| | For the nine months ended | | | |
|------------------------|---------------------------|---------------|---|---|
| | Sep 26, 2009 | Sep 27, 2008 | | |
| Marketing and sales | \$ 16,231,004 | \$ 18,703,915 | | |
| Percentage of revenues | 32.1 | 34.6 | % | % |

As a percentage of revenues, the decrease in marketing and sales expense was primarily the result of our cost reduction actions related to store payroll and advertising expenses, as described above.

General and administrative expense

General and administrative (“G&A”) expense consists of payroll and related expenses for executive, merchandising, finance and administrative personnel, as well as information technology, professional fees and other general corporate expenses. Our consolidated G&A expense for the first nine months of fiscal 2009 was \$5,006,742, or 9.9% of revenues, a decrease of \$483,334, or 0.3 percentage points, as a percentage of revenues, from the first nine months of the prior fiscal year.

| | For the nine months ended | | | |
|----------------------------|---------------------------|--------------|---|---|
| | Sep 26, 2009 | Sep 27, 2008 | | |
| General and administrative | \$ 5,006,742 | \$ 5,490,076 | | |
| Percentage of revenues | 9.9 | 10.2 | % | % |

General and administrative expense decreased as a percentage of revenues from the third quarter of the prior fiscal year as a result of the cost reduction initiatives implemented in 2009.

Operating loss

Our operating loss for the first nine months of fiscal 2009 was \$2,052,626, or 4.1% of revenues, compared to an operating loss of \$2,428,998, or 4.5% of revenues for the first nine months of the prior fiscal year.

Interest expense

Our interest expense in the first nine months of fiscal 2009 was \$390,849, a decrease of \$185,865 from the first nine months of the prior fiscal year. The decrease in the first nine months of fiscal 2009 was primarily due to lower average borrowing on our line of credit, a lower effective rate on our Highbridge Note which was paid in full on September 15, 2009 and lower interest expense on our Amscan Note, due to amortization of that indebtedness.

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Income taxes

We have not provided for income taxes for the first nine months of fiscal 2009 or fiscal 2008 due to availability of net operating loss (NOL) carryforwards to eliminate federal taxable income during those periods. No benefit has been recognized with respect to NOL carryforwards due to the uncertainty of future taxable income.

At the end of fiscal 2008, we had estimated federal net operating loss carryforwards of approximately \$20.3 million, which begin to expire in 2019. In accordance with Section 382 of the Internal Revenue Code, the use of these carryforwards will be subject to annual limitations based upon certain ownership changes of our stock that have occurred or that may occur.

Net Loss

Our net loss in the first nine months of fiscal 2009 was \$2,443,385, or \$0.11 per basic and diluted share, compared to a net loss of \$3,003,552, or \$0.13 per basic and diluted share, in the first nine months of the prior fiscal year. The decrease in net loss was mainly attributable to lower store payroll expenses, lower advertising costs and decreased general and administrative expenses.

Liquidity and Capital Resources

Our primary uses of cash are:

- purchases of inventory, including purchases under our Supply Agreement with Amscan, as described more fully below;
 - occupancy expenses of our stores;
 - employee salaries; and
- new store openings, including acquisitions.

Our primary sources of cash are:

- cash from operating activities; and
- debt, including our line of credit and note payable.

Our prospective cash flows are subject to certain trends, events and uncertainties, including demands for capital to support growth, improve our infrastructure, respond to economic conditions, and meet contractual commitments. Based on our current operating plan, we believe that anticipated revenues from operations and borrowings available under our line of credit, which was amended and restated on July 1, 2009, will be sufficient to fund our operations, working capital requirements, scheduled note payment as discussed below, and capital expenditures through the next twelve months. In the event that our operating plan changes due to changes in our strategic plans, lower-than-expected revenues, unanticipated expenses, increased competition, unfavorable economic conditions, further weakening of consumer confidence and spending, or other unforeseen circumstances, our liquidity may be negatively impacted. If so, we could be required to further adjust our expenditures for the remainder of 2009 and into 2010 to conserve working capital or raise additional capital, possibly including debt or equity financing, to fund operations and our business strategy and to refinance our outstanding debt. Given the current state of the debt and equity markets, this could be more difficult and expensive than recently refinanced debt.

Notes Payable

At the beginning of our fiscal year 2009 we had three notes payable outstanding. We refer to these notes as the Highbridge Note, the Amscan Note and the Party City Note. For a more detailed description of these notes, we refer

you to the section titled "Notes Payable" in the Notes to Consolidated Financial Statements for the quarter ended September 26, 2009 included in Item 1 of this Quarterly Report on Form 10-Q. In the third quarter of 2009, we paid in full the Highbridge Note and the Amscan Note. The Highbridge Note was paid off through additional borrowings under our line of credit with Wells Fargo. At September 26, 2009 only the Party City Note, with a principal balance of \$600,000 remained outstanding. The full principal amount is due at the note's maturity on August 7, 2010.

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In connection with the issuance of the Highbridge Note, we also issued a warrant, the Highbridge Warrant, exercisable for 2,083,334 shares of our common stock at an exercise price of \$0.475 per share, or 125% of the closing price of our common stock on the day immediately prior to the closing of the transaction. The agreements entered into in connection with the financing provide for certain restrictions and covenants consistent with Highbridge's status as a subordinated lender, and also grant Highbridge resale registration rights with respect to the shares of common stock underlying the Highbridge Warrant. The issuance of the Highbridge Warrant triggered certain anti-dilution provisions of our Series B, C, and D convertible preferred stock.

Line of Credit

On July 1, 2009, we entered into a Second Amended and Restated Credit Agreement (the "new line") with Wells Fargo, which amended and restated the previous revolving credit facility with Wells Fargo. The new line continues the revolving line of credit in the amount of up to \$12,500,000 and extends the maturity date for three years to July 2, 2012. As with the previous line with Wells Fargo, the new line includes an option whereby we may increase the revolving line of credit up to a maximum level of \$15,000,000 at any time prior to July 2, 2011. The amount of credit that is available from time to time under the Agreement is determined as a percentage of the value of eligible inventory plus a percentage of the value of eligible credit card receivables, as reduced by certain reserve amounts that may be required by Wells Fargo.

Borrowings under the new line will generally accrue interest at a margin ranging from 3.00% to 3.50% (determined according to the average daily excess availability during the fiscal quarter immediately preceding the adjustment date) over, at our election, either the London Interbank Offered Rate ("LIBOR") or a base rate determined by Wells Fargo from time to time. The new line margins are an increase over the previous line, and may result in an increase in overall borrowing cost under the new line. The new line also provides for letters of credit for up to a sublimit of \$2 million to be used in connection with inventory purchases and includes an unused line fee on the unused portion of the revolving credit line. The new line also provided for a closing fee of \$125,000, which was paid to Wells Fargo at closing. Our obligations under the new line continue to be secured by a lien on substantially all of our personal property.

Our inventory consists of party supplies which are valued at the lower of weighted-average cost or market and are reduced by an allowance for obsolete and excess inventory and are further reduced or increased by other adjustments, including vendor rebates and discounts and freight costs. Our line of credit availability calculation allows us to borrow against "acceptable inventory at cost", which is based on our inventory at cost and applies adjustments that our lender has approved, which may be different than adjustments we use for valuing our inventory in our financial statements, such as the adjustment to reserve for inventory shortage. The amount of "acceptable inventory at cost" was approximately \$18,316,461 at September 26, 2009.

Our accounts receivable consist primarily of credit card receivables and vendor rebate receivables. Our line of credit availability calculation allows us to borrow against "eligible credit card receivables", which are the credit card receivables for the previous two to three days of business. The amount of "eligible credit card receivables" was approximately \$300,413 at September 26, 2009.

Our total borrowing base is determined by adding the "acceptable inventory at cost" times an agreed upon advance rate plus the "eligible credit card receivables" times an agreed upon advance rate but not to exceed our established credit limit, which was \$12,500,000 at September 26, 2009. Under the terms of our line of credit, our \$12,500,000 credit limit was further reduced by (1) a minimum availability block, (2) customer deposits, (3) gift certificates, (4) merchandise credits and (5) outstanding letters of credit. The amounts outstanding under our line were \$4,741,878 at September 26, 2009 and \$1,950,019 as of December 27, 2008, an increase of \$2,791,859. Our additional availability was \$6,557,797 at September 26, 2009 and \$4,694,603 at December 27, 2008.

The outstanding balances under our line are classified as current liabilities in the accompanying consolidated balance sheets because we are required to apply daily lock-box receipts to reduce the amount outstanding.

As with the previous line, the new line has financial covenants that are limited to minimum availability and capital expenditures and contains various restrictive covenants, such as incurrence, payment or entry into certain indebtedness, liens, investments, acquisitions, mergers, dispositions and dividends. Under the new line, we are required to maintain a minimum availability of 7.5% of the credit limit, which is an increase from the previous requirement of 5% and, consistent with the previous line, to limit our capital expenditures to within 110% of those amounts included in our business plan, which may be updated from time to time. At September 26, 2009 we were in compliance with these financial covenants.

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The new line contains events of default customary for credit facilities of this type. Upon an event of default that is not cured or waived within any applicable cure periods, in addition to other remedies that may be available to Wells Fargo, the obligations under the new line may be accelerated, outstanding letters of credit may be required to be cash collateralized and the lenders may exercise remedies to collect the balance due, including to foreclose on the collateral. Should the new line be prepaid or the maturity accelerated for any reason, we would be responsible for an early termination fee in the amount of (i) 1.50% of the revolving credit facility ceiling then in effect within the first year of the term of the facility, (ii) 1.00% of the revolving credit facility ceiling then in effect within the second year of the term of the facility and (iii) 0.50% thereafter.

Supply Agreement with Amscan

Our Supply Agreement with Amscan gives us the right to receive certain additional rebates and more favorable pricing terms over the term of the agreement than generally were available to us under our previous terms with Amscan. The right to receive additional rebates, and the amount of such rebates, are subject to our achievement of increased levels of purchases and other factors provided for in the Supply Agreement. In exchange, the Supply Agreement obligates us to purchase increased levels of merchandise from Amscan until 2012. Beginning with calendar year 2008, the Supply Agreement requires us to purchase on an annual basis merchandise equal to the total number of our stores open during such calendar year, multiplied by \$180,000. The Supply Agreement provides for penalties in the event we fail to attain the annual purchase commitment that would require us to pay to Amscan the difference between the purchases for that year and the annual purchase commitment for that year. Under the terms of the Supply Agreement, the annual purchase commitment for any individual year can be reduced for orders placed by us but not filled by the supplier. During 2008, the supplier experienced difficulty in fulfilling certain of our orders sourced out of China. Accordingly, the supplier agreed to reduce our purchase commitment for 2008 to 90% of the contractual minimum for that year. Our purchases for 2008 exceeded the minimum purchase amount commitments, as adjusted, under the Supply Agreement. We believe that our purchases for 2009 will fall short of the annual commitment by approximately \$500,000. The supplier has agreed to allow the Company to roll over any shortfall for the year 2009 into future years' requirements. The Company is not aware of any reason that would prevent it from meeting the minimum purchase requirements, including any 2009 shortfall, for the remainder of the term of the Supply Agreement. Although we do not expect to incur any penalties under this Supply Agreement, if they were to occur, there could be a material adverse effect on our uses and sources of cash.

Operating, Investing and Financing Activities

Our operating activities provided \$320,856 during the nine months of 2009 compared to \$456,269 during the first nine months of 2008, a decrease of \$135,413. The decrease in cash provided by operating activities was primarily due to the timing of rent payments at the end of September 2009 compared to the timing of those payments at the end of September 2008.

We used \$347,724 in investing activities during the nine months of 2009 compared to \$1,993,878 during the first nine months of 2008, a decrease of \$1,646,154. The cash invested in the first nine months of 2009 was primarily due to the modification of our internal systems to improve our compliance with payment card industry data security standards and the relocation of our Walpole store to a new, larger location. The cash invested in the first nine months of 2008 was primarily due to the acquisition in January 2008 of two retail stores located in Rhode Island and the related non-compete agreement (see discussion below).

Our financing activities provided \$30,968 during the nine months of 2009 compared to providing \$1,528,640 during the first nine months of 2008, a decrease of \$1,497,672. The decrease was primarily related to the additional borrowings in 2008 related to the acquisition of the two retail stores in Rhode Island. As mentioned above, on January 2, 2008, we completed the purchase of two franchised Party City Corporation retail stores in Lincoln, Rhode Island and Warwick, Rhode Island. The aggregate consideration for the assets purchased and related non-competition

covenants was \$1,350,000, plus approximately \$195,000 for associated inventory, paid in cash at closing, on terms and conditions specified in the particular asset purchase agreement. Funding for the purchase was obtained from our line of credit with Wells Fargo.

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Contractual Obligations

Contractual obligations at September 26, 2009 were as follows:

| | Payments Due By Period | | | | Total |
|--|------------------------|--------------------------|--------------------------|------------------|---------------|
| | Within 1 Year | Within 2 - 3 Years | Within 4 - 5 Years | After 5 Years | |
| Line of credit | \$ 4,750,255 | \$ - | \$ - | \$ - | \$ 4,750,255 |
| Capital lease obligations | 11,400 | 19,950 | - | - | 31,350 |
| Notes payable | 662,626 | - | - | - | 662,626 |
| Supply agreement | 8,461,420 | 17,038,580 | - | - | 25,500,000 |
| Operating leases (including retail space leases) | 9,309,800 | 15,902,869 | 10,617,934 | 10,377,925 | 46,208,528 |
| Total contractual obligations | \$ 23,195,501 | \$ 32,961,399 | \$ 10,617,934 | \$ 10,377,925 | \$ 77,152,759 |

In addition, at September 26, 2009, we had outstanding purchase orders totaling approximately \$4,214,386 for the acquisition of inventory and non-inventory items that were scheduled for delivery after September 26, 2009.

Seasonality

Due to the seasonality of our business, sales and operating income are typically higher in our second and fourth quarters. Our business is highly dependent upon sales of Easter, graduation and summer merchandise in the second quarter and sales of Halloween and Christmas merchandise in the fourth quarter. We have typically operated at a loss during the first and third quarters.

Geographic Concentration

As of September 26, 2009, we operated a total of 50 stores, 45 of which are located in New England, and 5 of which are located in Florida, plus three temporary Halloween stores in Massachusetts and one temporary Halloween store in New Hampshire. As a result, a severe or prolonged regional recession or regional changes in demographics, employment levels, population, weather patterns, real estate market conditions, consumer confidence and spending patterns or other factors specific to the New England region or in Florida may adversely affect us more than a company that is more geographically diverse.

Effects of Inflation

While we do not view the effects of inflation as having a direct material effect upon our business, we believe that volatility in oil and gasoline prices impacts the cost of producing petroleum-based/plastic products, which are a key raw material in much of our merchandise, and also impacts prices of shipping products made overseas in foreign countries, such as China, which includes much of our merchandise. Volatile oil and gasoline prices also impact freight costs, consumer confidence and spending patterns. These and other issues directly or indirectly affecting our vendors and us could adversely affect our business and financial performance.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity,

capital expenditures or capital resources that are material to investors.

Factors That May Affect Future Results

Our business is subject to certain risks that could materially affect our financial condition, results of operations, and the value of our common stock. These risks include, but are not limited to, the ones described under Item 1A, “Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended December 27, 2008, and Part II, Item 1A, “Risk Factors” contained in our Quarterly Reports on Form 10-Q, including this one, and in our periodic reports filed with the Commission. Additional risks and uncertainties that we are unaware of, or that we may currently deem immaterial, may become important factors that harm our business, financial condition, results of operations, or the value of our common stock.

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Critical Accounting Policies

Our financial statements are based on the application of significant accounting policies, many of which require our management to make significant estimates and assumptions (see Note 2 to our consolidated financial statements for the fiscal year ended December 27, 2008 included in Item 8 of our Annual Report on Form 10-K for that fiscal year, as filed with the SEC on March 23, 2009). We believe the following accounting policies to be those most important to the portrayal of our financial condition and operating results and those that require the most subjective judgment. If actual results differ significantly from management's estimates and projections, there could be a material effect on our financial statements.

Inventories and Related Allowance for Obsolete and Excess Inventory

Inventories consist of party supplies and are valued at the lower of moving weighted-average cost or market. We record vendor rebates, discounts and certain other adjustments to inventory, including freight costs, and we recognize these amounts in the income statement as the related goods are sold.

During each interim reporting period, we estimate the impact on cost of products sold associated with inventory shortage. The actual inventory shortage is determined upon reconciliation of the annual physical inventory, which occurs shortly before and after our year end, and an adjustment to cost of products sold is recorded at the end of the fourth quarter to recognize the difference between the estimated and actual inventory shortage for the full year. The adjustment in the fourth quarter of 2008 included an estimated reduction of \$261,915 to the cost of products sold during the previous three quarters. The adjustment in the fourth quarter of 2007 included an estimated reduction of \$123,249 to the cost of products sold during the previous three quarters. The adjustment in the fourth quarter of 2006 included an estimated reduction of \$251,806 to the cost of products sold during the previous three quarters.

We also make adjustments to reduce the value of our inventory for an allowance for obsolete and excess inventory, which is based on our review of inventories on hand compared to estimated future sales. We conduct reviews periodically throughout the year on each stock keeping unit ("SKU"). As we identify obsolete and excess inventory, we take immediate measures to reduce our inventory risk on these items and we adjust our allowance accordingly. Thus, actual results could differ from our estimates.

Revenue Recognition

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale. We estimate returns based upon historical return rates and such amounts have not been significant.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and are depreciated on the straight-line method over the estimated useful lives of the assets. Expenditures for maintenance and repairs are charged to operations as incurred.

Intangible Assets

Intangible assets consist primarily of the values of two non-compete agreements acquired in conjunction with the purchase of retail stores in 2006 and 2008, and the values of retail store leases acquired in those transactions.

The first non-compete agreement, from Party City Corporation and its affiliates, covers Massachusetts, Maine, New Hampshire, Vermont, Rhode Island, and Windsor and New London counties in Connecticut, and expires in 2011. The second non-compete agreement was acquired in connection with our purchase in January 2008 of two franchised party

supply stores in Lincoln and Warwick, Rhode Island. The acquired Rhode Island stores had been operated as Party City franchise stores, and were converted to iParty stores immediately following the closing. The second non-compete agreement covers Rhode Island for five years from the date of closing and within a certain distance from our stores in the rest of New England for three years. Both non-compete agreements have an estimated life of 60 months and are subject to certain terms and conditions in their respective acquisition agreements.

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The occupancy valuations related to acquired retail store leases are for stores in Peabody, Massachusetts (estimated life of 90 months), Lincoln, Rhode Island (estimated life of 79 months) and Warwick, Rhode Island (estimated life of 96 months). Intangible assets also include legal and other transaction costs incurred related to the purchase of the Peabody, Lincoln and Warwick stores.

Non-compete agreements are amortized based on the pattern of their expected cash flow benefits. Occupancy valuations are amortized over the terms of the related leases.

Impairment of Long-Lived Assets

In connection with our ongoing long-lived asset assessment, we perform a review of each store for impairment indicators whenever events and changes in circumstances suggest that the carrying amounts may not be recoverable from estimated future store cash flows. Our review considers store operating results, future sales growth and cash flows. The conclusion regarding impairment may differ from current estimates if underlying assumptions or business strategies change. We closed two stores in early January 2008, at the end of their lease terms. No impairment charges were required for these stores, as the assets related to them have been fully amortized, except for immaterial amounts, and no liability existed for future lease costs. We are not aware of any impairment indicators for any of our remaining stores at September 26, 2009.

Income Taxes

Historically, we have not recognized an income tax benefit for our losses. Accordingly, we record a valuation allowance against our deferred tax assets because of the uncertainty of future taxable income and the realizability of the deferred tax assets. In determining if a valuation allowance against our deferred tax asset is appropriate, we consider both positive and negative evidence. The positive evidence that we considered included (1) we were able to use a portion of our net operating loss carryforwards in 2008, 2007 and 2006, (2) we have achieved positive comparable store sales growth for six out of the last seven years and (3) we had improved merchandise margins in 2007. The negative evidence that we considered included (1) we realized a net loss in 2005 and 2008, (2) our merchandise margins decreased in 2008, 2006 and 2005, (3) our future profitability is vulnerable to certain risks, including (a) the risk that we may not be able to generate significant taxable income to fully utilize our net operating loss carryforwards of approximately \$20.3 million at December 27, 2008, (b) the risk of unseasonable weather and other factors in a single geographic region, New England, where our stores are concentrated, (c) the risk of being so dependent upon a single season, Halloween, for a significant amount of annual sales and profitability and (d) the risk of fluctuating prices for petroleum products, which are a key raw material for much of our merchandise and which affect our freight costs and those of our suppliers and affect our customers' spending levels and patterns, (4) the risk that opening or acquiring new stores will put pressure on our profit margins until these stores reach maturity, (5) the expected costs of increased regulatory compliance, including, without limitation, professional fees associated with Section 404 of the Sarbanes-Oxley Act, which will likely have a negative impact on our profitability, (6) the current economic recession in the U.S. and the uncertainty as to the timing and strength of an economic recovery, further reduce discretionary spending or cause a shift in consumer discretionary spending to other products.

The negative evidence is strong enough for us to conclude that the level of our future profitability is uncertain at this time. We believe that it is prudent for us to maintain a valuation allowance against our deferred tax assets until we have a longer track record of profitability and we can reduce our exposure to the risks described above. Should we determine that we will be able to realize our deferred tax assets in the future, an adjustment to our deferred tax assets would increase income in the period in which we made such a determination.

Stock Option Compensation Expense

The Company uses the Black-Scholes option pricing model to determine the fair value of stock based compensation. The Black-Scholes model requires the Company to make several subjective assumptions, including the estimated length of time employees will retain their vested stock options before exercising them (“expected term”), and the estimated volatility of the Company’s common stock price over the expected term, which is based on historical volatility of the Company’s common stock over a time period equal to the expected term. The Black-Scholes model also requires a risk-free interest rate, which is based on the U.S. Treasury yield curve in effect at the time of the grant, and the dividend yield on the Company’s common stock, which is assumed to be zero since the Company does not pay dividends and has no current plans to do so in the future. Changes in these assumptions can materially affect the estimate of fair value of stock based compensation and consequently, the related expense recognized on the consolidated statement of operations. The Company recognizes stock based compensation expense on a straight-line basis over the vesting period of each grant.

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Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us 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 revenue and expenses during the reporting period. Our actual results could differ from our estimates.

New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standard (“SFAS”) No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162. This statement modifies the Generally Accepted Accounting Principles (“GAAP”) hierarchy by establishing only two levels of GAAP, authoritative and nonauthoritative accounting literature. Effective July 2009, the FASB Accounting Standards Codification (“ASC”), also known collectively as the “Codification,” is considered the single source of authoritative U.S. accounting and reporting standards, except for additional authoritative rules and interpretive releases issued by the SEC. Nonauthoritative guidance and literature would include, among other things, FASB Concepts Statements, American Institute of Certified Public Accountants Issue Papers and Technical Practice Aids and accounting textbooks. The Codification was developed to organize GAAP pronouncements by topic so that users can more easily access authoritative accounting guidance. It is organized by topic, subtopic, section, and paragraph, each of which is identified by a numerical designation. This statement applies beginning in third quarter 2009. All accounting references have been updated, and therefore SFAS references have been replaced with ASC references.

In April 2008, the FASB issued ASC 350-30-35-2, “Determination of the Useful Life of Intangible Assets”. ASC 350-30-35-2 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under ASC 350, “Intangibles - Goodwill and Other”. The intent of this amendment is to improve the consistency between the useful life of a recognized intangible asset under ASC 350 and the period of expected cash flows used to measure the fair value of the asset under ASC 805 “Business Combinations”, and other U.S. generally accepted accounting principles. The Company adopted the provisions of ASC 350-30-35-2 on December 28, 2008, and the adoption did not have a material impact on its financial position, results of operations or cash flows.

As permitted by ASC 820-10-65-1, Effective Date of ASC 820, “Fair Value Measurements and Disclosures”, the Company elected to defer the adoption of ASC 820 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, until December 28, 2008. The adoption of ASC 820-10-65-1 in fiscal 2009 has not had a material impact on the Company's financial position, results of operations or cash flows.

In May 2009, the FASB issued ASC 855, “Subsequent Events”, which provides guidance to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. ASC 855 also requires entities to disclose the date through which subsequent events were evaluated as well as the rationale for why that date was selected. ASC 855 is effective for interim and annual periods ending after June 15, 2009. ASC 855 is effective for us during our fiscal year ending December 26, 2009. We do not believe that the adoption of ASC 855 has had a material impact on our financial condition, results of operations, and disclosures.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There has been no material change in our market risk exposure since the filing of our Annual Report on Form 10-K for the period ended December 27, 2008, which was filed with the SEC on March 23, 2009.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures. The Chief Executive Officer and the Chief Financial Officer of iParty (its principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of September 26, 2009, the end of the fiscal quarter to which this report relates, that iParty's disclosure controls and procedures: are effective to ensure that information required to be disclosed by iParty in the reports filed or submitted by it under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and include controls and procedures designed to ensure that information required to be disclosed by iParty in such reports is accumulated and communicated to iParty's management, including the Chief Executive Officer and the Chief Financial Officer, to allow timely decisions regarding required disclosure. iParty's disclosure controls and procedures were designed to provide a reasonable level of assurance of reaching iParty's disclosure requirements and are effective in reaching that level of assurance.

(b) Changes in Internal Controls. No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) occurred during the fiscal quarter ended September 26, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II – OTHER INFORMATION

Item 1. Legal Proceedings

We are not a party to any material pending legal proceedings, other than ordinary routine matters incidental to our business, which we do not expect, individually or in the aggregate, to have a material effect on our financial position or results of operations.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the “Risk Factors” section of our Annual Report on Form 10-K for the fiscal year ended December 27, 2008, as filed with the SEC on March 23, 2009, and in our subsequent periodic reports filed with the SEC except as set forth below:

Our failure to generate sufficient cash to meet our liquidity needs may affect our ability to service our indebtedness and grow our business.

Our business requires access to capital to support growth, improve our infrastructure, respond to economic conditions, and meet contractual commitments. In the event that our current operating plan or long-term goals change due to changes in our strategic plans, lower-than-expected revenues, unanticipated expenses, increased competition, unfavorable economic conditions, other risk factors discussed in this report, or other unforeseen circumstances, our liquidity may be negatively impacted. Our ability to make payments on and to refinance our indebtedness, principally the amounts borrowed under our bank line of credit and \$600,000 note payable, and to fund any capital expenditures for systems upgrades and new store openings, if any, we may make in the future will depend in large part on our current and future ability to generate cash. This, to a certain extent, is subject to general economic, financial, competitive and other factors that are beyond our control. We cannot assure you that our business will generate sufficient cash flow from operations in the future, that our currently anticipated growth in revenues and cash flow will be realized on schedule, or that future borrowings will be available to us under our line of credit in an amount sufficient to enable us to service indebtedness, undertake store openings and replace and upgrade our technology systems to grow our business, or to fund other liquidity needs. If we need to refinance all or a portion of our indebtedness from other sources, we cannot assure you that we will be able to do so on terms and conditions acceptable to us.

We used our existing line of credit to pay off in full the \$2.5 million Highbridge Note on September 15, 2009, providing us with less availability under the line for working capital and acquisition needs than we might otherwise have. Our new bank line of credit with Wells Fargo allows us to borrow up to \$12,500,000, subject to a limitation based on qualified inventory, receivables levels and other reserves set by Wells Fargo, with an option to increase that limit up to \$15 million. As of September 26, 2009, there was \$4,741,878 outstanding under our line of credit with additional availability of \$6,557,797, which we believe to be sufficient to fund our operations, working capital requirements, the scheduled note payment in 2010, and capital expenditures for the next twelve months.

Compliance with changing regulation of corporate governance, public disclosure, and accounting standards may result in additional expense and risks.

Changing laws, regulations and standards relating to corporate governance, public disclosure and changes to accounting standards and practices, including the Sarbanes-Oxley Act of 2002, new SEC regulations, corporate law developments in Delaware, and evolving rules applicable to publicly-traded companies on the NYSE Amex, are creating uncertainty, and hence risks, for companies such as ours. These new or changed laws, regulations and standards are subject to varying interpretations due to the fact that they are new and there has not yet emerged a well-developed body of interpretation. As a result, their application in practice may evolve over time as new guidance

is provided by regulatory and governing bodies. This development could result in uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure, governance and accounting practices.

Our efforts to comply with evolving laws, regulations and standards have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. In particular, we have applied significant management and financial resources to document, test, monitor and enhance our internal control over financial reporting in order to meet the various current requirements of the Sarbanes-Oxley Act of 2002. Additional costs may be required to be incurred in 2009 and 2010 since current regulations will require our internal controls to be audited by our external auditors for fiscal year 2010. Currently, only management is required to certify as to the effectiveness of our internal controls. Any failure in the effectiveness of our internal control over financial reporting could have a material effect on our financial reporting or cause us to fail to meet reporting obligations, which upon disclosure, could negatively impact the market price of our common stock. Our efforts to comply with these types of new regulatory requirements regarding our required assessment of our internal controls over financial reporting and our external auditors' audit of our financial statements have required the commitment of increasing levels of financial and managerial resources. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies, we could face various material and adverse consequences, including, a decline in our common stock price or a possible delisting of our common stock.

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

Not applicable

Item 3. Defaults upon Senior Securities

Not applicable

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

Not applicable

Item 5. Other Information

Not applicable

Item 6. Exhibits

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q and are incorporated herein by reference.

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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.

iPARTY CORP.

By: /s/ SAL PERISANO
Sal Perisano
Chairman of the Board and Chief
Executive Officer
(Principal Executive Officer)

By: /s/ DAVID ROBERTSON
David Robertson
Chief Financial Officer
(Principal Financial and
Accounting Officer)

Dated: November 9, 2009

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EXHIBIT INDEX

EXHIBIT

NUMBER DESCRIPTION

- Ex. 10.1 Second Amended and Restated Credit Agreement among iParty Corp. and its wholly owned subsidiary iParty Retail Stores Corp., as borrowers, and Wells Fargo Retail Finance, LLC, as Administrative Agent, Collateral Agent, Swing Line Lender and Lender dated as of July 1, 2009. (Incorporated by reference from the Company's Current Report on Form 8-K filed with the Commission on July 6, 2009)
- Ex. 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- Ex. 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- Ex. 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350
- Ex. 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350