

IPARTY CORP  
Form 10-Q  
August 02, 2007

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

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**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange  
Act of 1934**

**For the Quarterly Period Ended June 30, 2007**

**OR**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act  
of 1934**

**For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 0-25507**

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**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)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one).

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Large accelerated filer  Accelerated filer  Non-accelerated filer

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 July 31, 2007 there were 22,643,722 shares of common stock, \$.001 par value, outstanding.

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**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**

	<b>Jun 30, 2007</b>	<b>Dec 30, 2006</b>
	<b>(Unaudited)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 65,015	\$ 760,376
Restricted cash	592,504	706,066
Accounts receivable	801,367	1,116,042
Inventory, net	13,970,586	12,264,737
Prepaid expenses and other assets	1,035,983	752,172
Total current assets	16,465,455	15,599,393
Property and equipment, net	4,508,648	4,817,993
Intangible assets, net	1,939,390	2,153,482
Other assets	102,030	126,505
Total assets	\$ 23,015,523	\$ 22,697,373
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 7,467,587	\$ 5,516,406
Accrued expenses	2,536,384	3,070,003
Current portion of capital lease obligations	30,473	343,761
Current notes payable	587,373	551,515
Borrowings under line of credit	1,476,163	1,162,719
Total current liabilities	12,097,980	10,644,404
Long-term liabilities:		
Capital lease obligations, net of current portion	25,834	42,456
Notes payable, net of discount \$443,192	3,487,943	3,736,309
Other liabilities	1,017,764	929,199
Total long-term liabilities	4,531,541	4,707,964
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; 470,401 and 471,401 shares issued and outstanding at Jun 30, 2007 and Dec 30, 2006, respectively (aggregate liquidation value of \$9,408,024 at Jun 30, 2007)		
	6,999,570	7,014,450
Series C convertible preferred stock - 100,000 shares authorized, issued and outstanding		

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(aggregate liquidation value of \$2,000,000 at Jun 30, 2007)	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 Jun 30, 2007)	3,652,500	3,652,500
Series E convertible preferred stock - 296,667 shares authorized, issued and outstanding (aggregate liquidation value of \$1,112,500 at Jun 30, 2007)	1,112,500	1,112,500
Series F convertible preferred stock - 114,286 shares authorized, issued and outstanding (aggregate liquidation value of \$500,000 at Jun 30, 2007)	500,000	500,000
Total convertible preferred stock	13,756,570	13,771,450
Common stock - \$.001 par value; 150,000,000 shares authorized; 22,622,825 and 22,603,877 shares issued and outstanding at Jun 30, 2007 and Dec 30, 2006, respectively	22,623	22,604
Additional paid-in capital	51,717,660	51,671,084
Accumulated deficit	(59,110,851)	(58,120,133)
Total stockholders' equity	6,386,002	7,345,005
Total liabilities and stockholders' equity	\$ 23,015,523	\$ 22,697,373

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

**iPARTY CORP.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	For the three months ended		For the six months ended	
	Jun 30, 2007	July 1, 2006	Jun 30, 2007	July 1, 2006
Revenues	\$ 20,411,919	\$ 18,587,169	\$ 36,011,078	\$ 32,132,968
Operating costs:				
Cost of products sold and occupancy costs	11,600,874	10,897,816	21,007,648	19,396,070
Marketing and sales	6,079,698	5,993,016	11,665,772	11,348,114
General and administrative	1,989,197	1,404,412	3,872,054	3,097,688
Operating income (loss)	742,150	291,925	(534,396)	(1,708,904)
Interest income	1,747	336	3,481	592
Interest expense	(231,759)	(170,329)	(459,803)	(328,113)
Income (loss) before income taxes	512,138	121,932	(990,718)	(2,036,425)
Income taxes	-	-	-	-
Net income (loss)	\$ 512,138	\$ 121,932	\$ (990,718)	\$ (2,036,425)
Income (loss) per share:				
Basic	\$ 0.01	\$ 0.00	\$ (0.04)	\$ (0.09)
Diluted	\$ 0.01	\$ 0.00	\$ (0.04)	\$ (0.09)
Weighted-average shares outstanding:				
Basic	38,199,738	37,728,932	22,618,685	22,545,872
Diluted	40,054,445	39,283,126	22,618,685	22,545,872

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

**iPARTY CORP.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>For the six months ended</b>	
	<b>Jun 30,</b>	<b>Jul 1, 2006</b>
	<b>2007</b>	
<b>Operating activities:</b>		
Net loss	\$ (990,718)	\$ (2,036,425)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	843,498	577,879
Deferred rent	88,565	110,936
Non cash stock based compensation expense	30,438	14,577
Non cash warrant expense	102,275	-
Changes in operating assets and liabilities:		
Accounts receivable	314,675	581,452
Inventory	(1,705,849)	(499,000)
Prepaid expenses and other assets	(295,837)	(634,767)
Accounts payable	1,951,181	2,829,194
Accrued expenses and other liabilities	(534,915)	(374,298)
Net cash (used in) provided by operating activities	(196,687)	569,548
<b>Investing activities:</b>		
Purchase of property and equipment	(305,163)	(179,997)
Net cash used in investing activities	(305,163)	(179,997)
<b>Financing activities:</b>		
Net borrowings under line of credit	313,444	961,582
Principal payments on notes payable	(314,783)	-
Decrease in restricted cash	113,562	102,023
Principal payments on capital lease obligations	(329,910)	(230,827)
Deferred financing costs	22,899	(87,353)
Proceeds from exercise of stock options	1,277	1,170
Net cash (used in) provided by financing activities	(193,511)	746,595
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(695,361)</b>	<b>1,136,146</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>760,376</b>	<b>699,194</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 65,015</b>	<b>\$ 1,835,340</b>
<b>Supplemental disclosure of non-cash financing activities:</b>		
Conversion of Series B convertible preferred stock to common stock	\$ 14,880	\$ 7,451

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



**iPARTY CORP.**  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
**June 30, 2007**  
(Unaudited)

**1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES:**

*Interim Financial Information*

The interim consolidated financial statements as of June 30, 2007 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 generally accepted accounting principles. The consolidated balance sheet at December 30, 2006 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 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 30, 2006.

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries 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.

*Concentrations*

The Company purchases its inventory from a diverse group of vendors. Three suppliers account for approximately 36% of the Company's purchase of merchandise, 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, which will obligate the Company to purchase increased levels of merchandise until 2012. The Supply Agreement provides for a ramp-up period during 2006 and 2007 and, for five years beginning with calendar year 2008, 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. The Company is not aware of any reason or circumstance that would prevent the minimum purchase amount commitments under the Supply Agreement from being met.

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.

*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.

The Company uses controlled disbursement banking arrangements as part of its cash management program. Outstanding checks, which were included in accounts payable, totaled \$1,702,446 at June 30, 2007 and \$2,316,026 at December 30, 2006. The decrease in outstanding checks as of June 30, 2007 is due to the timing of store lease payments.

Restricted cash represents funds on deposit established for the benefit of and under the control of Wells Fargo Retail Finance II, LLC, 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 capital lease obligations approximates the carrying value. The fair value of the notes payable approximates the carrying value. The fair value of the warrants was determined by using the Black-Scholes model (volatility of 108%, interest of 4.73% and expected life of five years).

*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:

	<b>Six months ended Jun 30, 2007</b>	<b>Twelve months ended Dec 30, 2006</b>
Beginning balance	\$ 1,079,814	\$ 1,098,972
Increases to reserve	190,000	524,550
Write-offs against reserve	(2,232)	(543,708)
Ending balance	\$ 1,267,582	\$ 1,079,814

*Income Taxes*

The Company adopted the provisions of Financial Accounting Standards Board (“FASB”) Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109” (“FIN 48”) on December 31, 2006. At the adoption date and as of June 30, 2007, the Company had no material unrecognized tax benefits and no adjustments to liabilities, retained earnings or operations were required.

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The Company recognizes interest and penalties related to uncertain tax positions in income tax expense which were zero for the six months ended June 30, 2007.

Tax years 2003 through 2006 are subject to examination by the federal and state taxing authorities. There are no income tax examinations currently in process.

#### *Net Income (Loss) per Share*

Net income (loss) per basic share is computed by dividing net income (loss) by the weighted average number of common shares outstanding plus the common share equivalents of Series B-F preferred stock. The common share equivalents of Series B-F are included in the calculation of net income (loss) per basic share in accordance with EITF Topic D-95, *Effect of Participating Convertible Securities on the Computation of Basic Earnings Per Share*, since the preferred stockholders are entitled to participate in dividends when and if declared by the Board of Directors. For periods with net losses, the Company excludes those common share equivalents since their impact would be anti-dilutive.

Net income (loss) per diluted share is computed by dividing net income (loss) by the weighted average number of common shares outstanding, plus the common share equivalents of Series B-F preferred stock, plus the common share equivalents of the "in the money" stock options and warrants as computed by the treasury method. For periods with net losses, the Company excludes those common share equivalents since their impact would be anti-dilutive.

As of June 30, 2007, there were 28,433,195 potential additional common share equivalents outstanding, which were not included in the calculation of diluted net loss per share for the six months then ended because their effect would be anti-dilutive. These included 15,576,913 shares upon the conversion of immediately convertible preferred stock, 2,083,334 shares upon the exercise of a warrant with an exercise price of \$0.475 per share, 528,210 shares upon the exercise of warrants with a weighted average exercise price of \$3.79 per share and 10,244,738 shares upon the exercise of stock options with a weighted average exercise price of \$0.59 per share.

#### *Stock Option Compensation Expense*

On January 1, 2006, the Company adopted the Financial Accounting Standards Board ("FASB") Statement No. 123(R), *Share-Based Payments*, using the modified prospective method. Under this method, stock based compensation expense is recognized for new grants beginning in 2006 and any unvested grants prior to the adoption of Statement No. 123(R). Prior to fiscal 2006, the Company accounted for share-based payments to employees using the Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and the disclosure-only provisions of Statement No. 123, *Accounting for Stock-Based Compensation*. Because the Company granted stock options to employees at exercise prices equal to fair market value on the date of grant, no stock based compensation cost was recognized for option grants in periods prior to fiscal 2006.

In response to Statement No. 123(R), on September 21, 2005, the Company's Board of Directors approved an acceleration of the vesting of certain unvested and "out-of-the-money" stock options previously awarded to employees and officers with exercise prices equal to or greater than \$0.69 per share. Options held by non-employee directors were excluded from the vesting acceleration. As a result, options to purchase approximately 1.0 million shares of the Company's common stock became exercisable immediately. Based upon the Company's closing stock price of \$0.46 on September 21, 2005, none of these options had intrinsic value on the date of acceleration.

In making the decision to accelerate these options, the Company's Board of Directors considered the interest of the stockholders as it would reduce the Company's reported stock based compensation expense in future periods following the effectiveness of Statement No. 123(R). The future stock based compensation expense that was eliminated was approximately \$508,000 on a pre-tax basis.

Under Statement No. 123(R), 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. Under the modified prospective method, stock based compensation expense is recognized for new grants beginning in the fiscal year ended December 30, 2006 and any unvested grants prior to the adoption of Statement No. 123(R). 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 six months ended	
	Jun 30, 2007	Jul 1, 2006	Jun 30, 2007	Jul 1, 2006
Stock Based Compensation Expense	\$ 19,546	\$ 6,887	\$ 30,438	\$ 14,577

Stock based compensation expense is included in general and administrative expense. The adoption of Statement No. 123(R) had no impact on cash flow from operations and cash flow from financing activities for the six months ended June 30, 2007.

Under the Company's Amended and Restated 1998 Incentive and Nonqualified Stock Option Plan (the "1998 Plan") options to acquire 11,000,000 shares of common stock may be granted to officers, directors, key employees and consultants. The exercise price for qualified incentive options cannot be less than the fair market value of the stock on the grant date and the exercise price of nonqualified options can be fixed by the Board. Options to purchase the Company's common stock under the 1998 Plan have been granted to employees, directors and consultants of the Company at fair market value at the date of grant. Generally, the 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 1,350,000 shares of common stock to key employees and each of the four independent members of the Board of Directors on June 6, 2007 at an exercise price of \$0.42 per share. Similarly, the Company granted options for the purchase of 25,000 shares of common stock to each of the four independent members of the Board of Directors on June 7, 2006 at an exercise price of \$0.36 per share. The weighted-average fair market value using the Black-Scholes option-pricing model of the options granted was \$0.33 per share for the three and six months ended June 30, 2007, and was \$0.30 per share for the three and six months ended July 1, 2006. The fair market value of the stock options at the date of the grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the three months ended		For the six months ended	
	Jun 30, 2007	Jul 1, 2006	Jun 30, 2007	Jul 1, 2006
Risk-free interest rate	4.94%	5.18%	4.94%	5.18%
Expected volatility	102.6%	115.6%	102.6%	115.6%
Weighted average expected life (in years)	5.0	5.0	5.0	5.0
Expected dividends	0.00%	0.00%	0.00%	0.00%

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

	<b>Number of Stock Options</b>	<b>Weighted Average Exercise Price</b>	<b>Price Range</b>	<b>Weighted Average Remaining Life (Years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding - December 30, 2006	8,922,440	\$ 0.62	\$ 0.13 - \$ 4.25		
Granted	1,350,000	0.42	0.42 - 0.42		
Expired/Forfeited	(22,150)	0.38	0.20 - 0.69		
Exercised	(5,552)	0.23	0.23 - 0.23		
Outstanding - June 30, 2007	10,244,738	\$ 0.59	\$ 0.13 - \$ 4.25	5.2	\$ 823,743
Exercisable - June 30, 2007	8,848,844	\$ 0.62	\$ 0.13 - \$ 4.25	4.5	\$ 810,192
Available for grant - June 30, 2007	330,851				

The following table summarizes information for options outstanding and exercisable at June 30, 2007:

<b>Price Range</b>	<b>Number of Stock Options</b>	<b>Outstanding</b>		<b>Exercisable</b>	
		<b>Weighted Average Remaining Life (Years)</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Stock Options</b>	<b>Weighted Average Exercise Price</b>
\$ 0.13 - \$ 0.20	139,250	4.1	\$ 0.18	139,250	\$ 0.18
0.21 - 0.30	3,798,132	3.7	0.25	3,797,233	0.25
0.31 - 0.50	2,511,805	7.7	0.39	1,130,888	0.35
0.51 - 1.00	3,154,351	5.7	0.77	3,140,273	0.77
1.01 - 3.50	541,200	2.1	2.33	541,200	2.33
3.51 - 4.25	100,000	2.5	4.14	100,000	4.14
<b>Total</b>	<b>10,244,738</b>	<b>5.2</b>	<b>\$ 0.59</b>	<b>8,848,844</b>	<b>\$ 0.62</b>

The total fair value of shares vested during the six months ended June 30, 2007 was \$4,707. The remaining unrecognized stock based compensation expense related to unvested awards at June 30, 2007, was \$447,070 and the period of time over which this expense will be recognized is 4.5 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:

<b>Asset Classification</b>	<b>Estimated Useful Life</b>
Leasehold improvements	Lesser of term of lease or 10 years
Furniture and fixtures	7 years
Computer hardware and software	3 years
Equipment	5 years

*Intangible Assets*

Intangible assets consist primarily of the value of a five-year non-compete agreement from Party City Corporation and its affiliates that covers Massachusetts, Maine, New Hampshire, Vermont, Rhode Island, and Windsor and New London counties in Connecticut which expires in 2011. This asset has an estimated life of 60 months. Also included is the value related to the retail store lease that the Company acquired from Party City in Peabody, Massachusetts. This asset has an estimated life of 90 months. The other intangible assets consist of legal and other transaction fees related to the three-year note payable due on September 15, 2009. These assets are being amortized over the life of the note payable.

Intangible assets as of June 30, 2007 and December 30, 2006 were:

	<b>Jun 30, 2007</b>	<b>Dec 30, 2006</b>
Non-compete agreement	\$ 1,725,069	1,725,069
Occupancy valuation	460,000	460,000
Other	169,848	154,949
<b>Intangible assets</b>	<b>2,354,917</b>	<b>2,340,018</b>
<b>Less: accumulated amortization</b>	<b>(415,527)</b>	<b>(186,536)</b>
<b>Intangible assets, net</b>	<b>\$ 1,939,390</b>	<b>\$ 2,153,482</b>

Amortization expense for these intangible assets was:

	<b>For the three months ended</b>		<b>For the six months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
Amortization expense	\$ 114,498	\$ -	\$ 228,996	\$ -

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



Future amortization expense related to these intangible assets as of June 30, 2007:

<b>Year</b>	<b>Amount</b>
2007	\$ 228,998
2008	460,976
2009	443,760
2010	409,327
2011	265,571
Thereafter	130,758
<b>Total</b>	<b>\$ 1,939,390</b>

#### *Accounting for the Impairment of Long-Lived Assets*

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal 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 fourth quarter of 2006, the Company decided to close its store in East Providence, Rhode Island effective November 4, 2006 due to underperforming sales. As a result of this closing, the Company incurred a charge in the fourth quarter of 2006 of approximately \$120,000 related to remaining lease payments and other closing costs. The initial term of the lease is due to expire on August 31, 2007. The Company is not aware of any impairment indicators in any of its remaining stores at June 30, 2007.

#### *Notes Payable*

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

The "Highbridge Note" is a three year subordinated note that bears interest at the rate of prime plus one percent. The note matures on September 15, 2009. The original discount associated with warrants issued in conjunction with the Highbridge Note (original discount amount \$613,651) is being amortized using the effective interest method over the life of the note payable. The note payable is presented net of the remaining unamortized discount.

The "Amscan Note" is a subordinated promissory note in the total principal amount of \$1,819,373. The note bears interest at the rate of 11.0% per annum and is payable in thirty-six (36) equal monthly installments of principal and interest of \$59,562 beginning on November 1, 2006, and on the first day of each month thereafter until October 1, 2009, when the entire remaining principal balance and all accrued interest are due and payable.

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.

#### *Stockholder's Equity*

During the six months ended June 30, 2007, 5,552 shares of common stock were issued upon the exercise of stock options and 13,396 shares of common stock were issued upon conversion of Series B convertible preferred stock.

#### *Reclassifications*

Certain prior year balances have been reclassified to conform with current year presentation.



## 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 30, 2006.*

*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 30, 2006.*

### Overview

We believe 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](http://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 26 stores in Massachusetts, 7 in Connecticut, 6 in New Hampshire, 2 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 20,300 square feet and average approximately 9,800 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:

	<b>For the six months ended</b>	
	<b>Jun 30,</b>	<b>Jul 1, 2006</b>
	<b>2007</b>	
Beginning of period	50	50
Openings / Acquisitions	-	-
Closings	-	-
End of period	50	50

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 and Hanukkah. We also focus our business closely on lifetime events such as anniversaries, graduations, birthdays, and bridal or baby showers.

Our business has a seasonal pattern. In the past three years, we have realized approximately 37.5% of our annual revenues in our fourth quarter, which includes Halloween and Christmas, and approximately 23.4% of our revenues in the second quarter, which includes school graduations. 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 remainder of 2007, our plan continues to be to increase our comparable store sales growth, increase our gross profit margin percentage and leverage our occupancy costs, marketing and sales expense and general and administrative expense. From time to time, we have been and expect to continue to be presented with opportunities to open new party supplies stores or acquire existing ones. We intend to continue to evaluate such opportunities on a case-by-case basis as they may arise to ascertain if they would be a good strategic fit for our business and would help us increase shareholder value.

### **Results of Operations**

Fiscal year 2007 has 52 weeks and ends on December 29, 2007. Fiscal year 2006 had 52 weeks and ended on December 30, 2006.

The second quarter of fiscal year 2007 had 13 weeks and ended on June 30, 2007. The second quarter of fiscal year 2006 had 13 weeks and ended on July 1, 2006.

### **Three Months Ended June 30, 2007 Compared to Three Months Ended July 1, 2006**

#### *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 second quarter of fiscal 2007 were \$20,411,919, an increase of \$1,824,750, or 9.8% from the second quarter of the prior fiscal year.

	<b>For the three months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
Revenues	\$ 20,411,919	\$ 18,587,169
Increase in revenues	9.8%	12.5%

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Sales for the second quarter of fiscal 2007 included sales from 49 comparable stores (defined as stores open for at least one full year) and one store that was acquired in August 2006. Comparable store sales for the quarter increased by 5.9%.

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*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 second quarter of fiscal 2007 were \$11,600,874, or 56.8% of revenues, an increase of \$703,058 and a decrease of 1.8 percentage points, as a percentage of revenues, from the second quarter of the prior fiscal year.

	<b>For the three months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
Cost of products sold and occupancy costs	\$ 11,600,874	\$ 10,897,816
Percentage of revenues	56.8%	58.6%

As a percentage of revenues, the decrease in cost of products sold and occupancy costs was primarily attributable to improved leveraging of occupancy costs resulting from the increased sales in our comparable stores and better pricing negotiated from vendors.

*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 second quarter of fiscal 2007 was \$6,079,698, or 29.8% of revenues, an increase of \$86,682 and a decrease of 2.4 percentage points, as a percentage of revenues, from the second quarter of the prior fiscal year.

	<b>For the three months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
Marketing and sales	\$ 6,079,698	\$ 5,993,016
Percentage of revenues	29.8%	32.2%

As a percentage of revenues, the decrease in marketing and sales expense was primarily attributable to better leveraging of store payroll and other store selling related expenses resulting from the increased sales in our comparable stores.

*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 second quarter of fiscal 2007 was \$1,989,197, or 9.7% of revenues, an increase of \$584,785 and an increase of 2.1 percentage points, as a percentage of revenues, from the second quarter of the prior fiscal year.

	<b>For the three months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
	\$ 1,989,197	\$ 1,404,412



General and  
administrative

Percentage of  
revenues

9.7%

7.6%

As a percentage of revenues, the increase in G&A expense is largely attributable to executive recruitment costs and professional fees associated with our compliance activities related to Section 404 of the Sarbanes-Oxley Act.

*Operating income*

Our operating income for the second quarter of fiscal 2007 was \$742,150, or 3.6% of revenues, compared to an operating income of \$291,925, or 1.6% of revenues for the second quarter of the prior fiscal year.

*Interest expense*

Our interest expense in the second quarter of fiscal 2007 was \$231,759, an increase of \$61,430 from the second quarter of the prior fiscal year. The increase in the second quarter of fiscal 2007 was primarily due to interest, including amortization of discount, related to notes payable that we entered into in fiscal 2006.

*Income taxes*

We have not provided for income taxes for the second quarter of fiscal 2007 or fiscal 2006 due to the availability of net operating loss (NOL) carryforwards to eliminate 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 2006, we had estimated net operating loss carryforwards of approximately \$23.0 million, which begin to expire in 2018. 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 Income*

Our net income in the second quarter of fiscal 2007 was \$512,138, or \$0.01 per basic and diluted share, compared to a net income of \$121,932, or \$0.00 per basic and diluted share, in the second quarter of the prior fiscal year.

**Six Months Ended June 30, 2007 Compared to Six Months Ended July 1, 2006***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 six months of fiscal 2007 were \$36,011,078, an increase of \$3,878,110, or 12.1% from the first six months of the prior fiscal year.

	<b>For the six months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
Revenues	\$ 36,011,078	\$ 32,132,968
Increase in revenues	12.1%	8.3%

Sales for the first six months of fiscal 2007 included sales from 49 comparable stores (defined as stores open for at least one full year) and one store that was acquired in August 2006. Comparable store sales for the first six months increased by 8.1%.

*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 six months of fiscal 2007 were \$21,007,648, or 58.3% of revenues, an increase of \$1,611,578 and a decrease of 2.1 percentage points, as a percentage of revenues, from the first six months of the prior fiscal year.

	<b>For the six months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
Cost of products sold and occupancy costs	\$ 21,007,648	\$ 19,396,070
Percentage of revenues	58.3%	60.4%

As a percentage of revenues, the decrease in cost of products sold and occupancy costs was primarily attributable to improved leveraging of occupancy costs resulting from the increased sales in our comparable stores and better pricing negotiated from vendors.

*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 six months of fiscal 2007 was \$11,665,772, or 32.4% of revenues, an increase of \$317,658 and a decrease of 2.9 percentage points, as a percentage of revenues, from the first six months of the prior fiscal year.

	<b>For the six months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
Marketing and sales	\$ 11,665,772	\$ 11,348,114
Percentage of revenues	32.4%	35.3%

As a percentage of revenues, the decrease in marketing and sales expense was primarily attributable to better leveraging of store payroll and other store selling related expenses resulting from the increased sales in our comparable stores.

*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 six months of fiscal 2007 was \$3,872,054, or 10.8% of revenues, an increase of \$774,366 and an increase of 1.2 percentage points, as a percentage of revenues, from the first six months of the prior fiscal year.

	<b>For the six months ended</b>	
	<b>Jun 30, 2007</b>	<b>Jul 1, 2006</b>
	\$ 3,872,054	\$ 3,097,688

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General and  
administrative

Percentage of revenues	10.8%	9.6%
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As a percentage of revenues, the increase in G&A expense is largely attributable to executive recruitment costs and professional fees associated with our compliance activities related to Section 404 of the Sarbanes-Oxley Act.

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### *Operating loss*

Our operating loss for the first six months of fiscal 2007 was \$534,396, or 1.5% of revenues, compared to an operating loss of \$1,708,904, or 5.3% of revenues for the first six months of the prior fiscal year.

### *Interest expense*

Our interest expense in the first six months of fiscal 2007 was \$459,803, an increase of \$131,690 from the first six months of the prior fiscal year. The increase in the first six months of fiscal 2007 was primarily due to interest, including amortization of discount, related to notes payable that we entered into in fiscal 2006.

### *Income taxes*

We have not provided for income taxes for the first six months of fiscal 2007 or fiscal 2006 due to availability of net operating loss (NOL) carryforwards to eliminate 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 2006, we had estimated net operating loss carryforwards of approximately \$23.0 million, which begin to expire in 2018. 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 six months of fiscal 2007 was \$990,718, or \$0.04 per basic and diluted share, compared to a net loss of \$2,036,425, or \$0.09 per basic and diluted share, in the first six months of the prior fiscal year.

## **Liquidity and Capital Resources**

Our operating activities used \$196,687 in the first six months of fiscal 2007 compared to \$569,548 in cash provided in the first six months of the prior fiscal year, a decrease of \$766,235. The increase in cash used in operating activities was primarily due to higher purchases of inventory and a decrease in accounts payable growth primarily related to extended dating from vendors in the first half of 2006.

We used \$305,163 in investing activities in the first six months of fiscal 2007 compared to \$179,997 in the first six months of the prior fiscal year. The cash invested in the first six months of fiscal 2007 was primarily due to the implementation of a new human resource information and payroll system. The cash invested in the first six months of fiscal 2006 was primarily for fixed assets associated with existing store improvements and computer replacements.

We used \$193,511 in financing activities in the first six months of fiscal 2007 compared to providing \$746,595 in the first six months of the prior fiscal year, a decrease of \$940,106. We increased our borrowings under our line of credit by \$313,444 in the first six months of fiscal 2007 (to \$1.5 million) compared to an increase of \$961,582 in the first six months of fiscal 2006 (to \$7.6 million). The amount outstanding under our line of credit at the end of the second quarter of fiscal 2007 was lower than the amount at the end of the second quarter of fiscal 2006 primarily due to paying the line of credit down with funds received from a \$2.5 million note payable that we entered into during the third quarter of 2006 and better operating results.

On December 21, 2006, we amended and restated our existing line of credit (the "line") with Wells Fargo Retail Finance II, LLC. The amendment continues the line of credit with Wells Fargo at \$12,500,000 (including the \$500,000 term loan) and extends it for three additional years to January 2, 2010. In addition, the new agreement with Wells Fargo

includes an option whereby we may increase our line of credit up to a maximum level of \$15,000,000, upon 15 days written notice, as long as we are in compliance with all debt covenants and the other provisions of the loan agreement. Borrowings under the new line bear interest at Wells Fargo's base rate or, at our option, at London Interbank Offered Rate ("LIBOR") plus 1.75%. Beginning March 30, 2007, these rates can increase by no more than 0.25% if average availability under the line falls below \$3,000,000. Borrowings under the line are based on inventory and accounts receivable levels. The line is secured by a lien on substantially all of our assets.

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The amended and restated agreement includes a financial covenant requiring us to maintain a minimum availability under the line of 5% of the credit limit. At the current credit limit of \$12,500,000, the minimum availability is \$625,000. The amended agreement also has a covenant that requires us 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 June 30, 2007, we were in compliance with these financial covenants. The line generally prohibits the payment of any dividends or other distributions to any of our classes of capital stock.

On January 17, 2006, we had amended our then-existing agreement with Wells Fargo to allow for a \$500,000 term loan which increased our borrowing base, but did not increase the \$12.5 million credit limit. We borrowed the full \$500,000 on that date. On October 30, 2006, we further amended our agreement to extend the maturity date of our outstanding term loan in the amount of \$500,000 from October 31, 2006 to January 2, 2007. On December 21, 2006, in connection with the amendment described in the preceding paragraph, we extended the maturity date of this \$500,000 term loan to October 31, 2007. We repaid the term loan on March 2, 2007.

The amount outstanding under the line was \$1,476,163 as of June 30, 2007 and \$1,162,719 as of December 30, 2006. The interest rate on these borrowings was 7.9% at June 30, 2007 and 8.6% at December 30, 2006. The outstanding balances under the line are classified as current liabilities in the accompanying consolidated balance sheets since we are required to apply daily lock box receipts to reduce the amount outstanding.

Our inventory consists of party supplies which are valued at the lower of moving weighted-average cost or market and are reduced by an allowance for obsolete and excess inventory and other adjustments, including vendor rebates, 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 from 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 \$14,609,900 at June 30, 2007.

Our accounts receivable consist primarily of vendor rebate receivables and credit card 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 \$292,815 at June 30, 2007.

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 June 30, 2007. 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. Therefore, our additional availability was \$6,441,972 at June 30, 2007 and \$5,657,200 at December 30, 2006.

On August 7, 2006, we entered into and simultaneously closed an asset purchase agreement with Party City, an affiliate of Amscan Holdings, Inc., pursuant to which we 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 bears interest at the rate of 12.25% per annum (the “Party City Note”) and \$1,850,000 in cash. The Party City Note 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 September 15, 2006, we entered into a securities purchase agreement pursuant to which we raised \$2.5 million through a combination of subordinated debt and warrant issued on September 15, 2006 to Highbridge International LLC (“Highbridge”), an institutional accredited investor. Under the terms of the financing, we issued Highbridge a three-year subordinated note (the “Highbridge Note”) that bears interest at an interest rate of prime plus one percent. The note matures on September 15, 2009. In addition, we issued Highbridge 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. We allocated approximately \$613,651 of value to the warrants using the Black-Scholes model (volatility of 108%, interest of 4.73% and expected life of five years). The note discount associated with the warrants is being amortized using the effective interest method over the life of the note payable.



Our prospective cash flows are subject to certain trends, events and uncertainties, including our operating results for the Halloween season, which is our single most important season, as well as demands for working capital to improve our infrastructure, respond to economic conditions, take advantage of strategic opportunities, support growth, and meet our contractual commitments.

Based on our current operating plan, we believe that anticipated revenues from operations and borrowings available under our line of credit will be sufficient to fund our operations and working capital requirements through at least the next twelve months.

Contractual obligations at June 30, 2007 were as follows:

	<b>Payments Due By Period</b>					<b>Total</b>
	<b>Within 1 Year</b>	<b>Within 2 - 3 Years</b>	<b>Within 4 - 5 Years</b>	<b>After 5 Years</b>		
Line of credit	\$ 1,476,163	\$ -	\$ -	\$ -	\$ -	\$ 1,476,163
Capital lease obligations	30,473	25,834	-	-	-	56,307
Notes payable	587,373	3,331,135	600,000	-	-	4,518,508
Supply agreement		18,000,000	18,000,000	9,000,000		45,000,000
Operating leases (including retail space leases)	8,070,949	14,276,114	10,680,405	9,723,395		42,750,863
Total contractual obligations	\$ 10,164,958	\$ 35,633,083	\$ 29,280,405	\$ 18,723,395		\$ 93,801,841

In addition, at June 30, 2007, we had outstanding purchase orders totaling approximately \$9,198,611 for the acquisition of inventory and non-inventory items that are scheduled for delivery after June 30, 2007.

### 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 historically operated at a loss during the first and third quarters.

### Geographic Concentration

As of June 30, 2007, we operated a total of 50 stores, 45 of which are located in New England. 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 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 to ship products made overseas in foreign countries, such as China, which includes much of our merchandise. Volatile oil and gasoline prices also impact our freight costs, and consumer confidence and spending patterns. These and other issues directly or indirectly affecting our vendors, our customers and us could adversely affect our business and financial performance.



## **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 30, 2006 and Part II, Item 1A, "Risk Factors" of subsequent Quarterly Reports on Form 10-Q, including this one. 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.

## **Critical Accounting Policies and Estimates**

Our financial statements are based on the application of significant accounting policies, many of which require management to make significant estimates and assumptions (see Note 1 to the Consolidated Financial Statements). We believe the following accounting policies to be those most important to the portrayal of our financial condition 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.

### *Inventory and Related Allowance for Obsolete and Excess Inventory*

Our inventory consists of party supplies and is 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.

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.

### *Impairment of Long-Lived Assets*

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, 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. During the fourth quarter of 2006, we decided to close our store in East Providence, Rhode Island effective November 4, 2006 due to underperforming sales. As a result of this closing, we incurred a charge in the fourth quarter of 2006 of approximately \$120,000 related to remaining lease payments and other closing costs. The initial term of the lease is due to expire on August 31, 2007. We are not aware of any impairment indicators in any of our remaining stores at June 30, 2007.

### *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 profitable in 2006, 2004 and 2003 due to the success of our Halloween seasons, (2) we have achieved positive comparable store sales growth for the last three full years and (3) improved merchandise margins in 2006, 2004 and 2003. The negative evidence that we considered included (1) after two years of profitability we realized a net loss in 2005, (2) our merchandise margins decreased in 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 \$23.0 million, (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 rising 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 costs of opening new stores will put pressure on our profit margins until these stores reach maturity, (5) the risk that investment in infrastructure will increase our costs and (6) the expected costs of increased regulatory compliance, including, without limitation, those associated with Section 404 of the Sarbanes-Oxley Act, will likely have a negative impact on our profitability.

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 until we have a longer history of sustained 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 reduce our deferred tax asset valuation allowance would increase income in the period we made such a determination.

We adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN 48") on December 31, 2006. At the adoption date and as of June 30, 2007, we had no material unrecognized tax benefits and no adjustments to liabilities, retained earnings or operations were required.

We recognize interest and penalties related to uncertain tax positions in income tax expense which were zero for the six months ended June 30, 2007.

Tax years 2003 through 2006 are subject to examination by the federal and state taxing authorities. There are no income tax examinations currently in process.



### *Stock Option Compensation Expense*

On January 1, 2006, we adopted Statement No. 123(R) using the modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement No. 123 for all awards granted to employees prior to the effective date of Statement No. 123(R) that remain unvested on the effective date. Prior to January 1, 2006, we accounted for our stock option compensation agreements with employees under the provisions of Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees* and the disclosure-only provisions of Statement No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of Financial Accounting Standards Board (“FASB”) Statement No. 123*.

### *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 revenues and expenses during the reporting period. Our actual results could differ from our estimates.

### *Fair Value Measurements*

On December 31, 2006, we adopted SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but its provisions apply to all other accounting pronouncements that require or permit fair value measurement. Adoption of SFAS No. 157 does not have a material impact on our financial position or results of operations.

### **New Accounting Pronouncements**

No new accounting pronouncements were issued during the quarter ended June 30, 2007 that are expected to have a material impact on our financial position or results of operations.

### **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.

### **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 June 30, 2007, 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 are designed to provide a reasonable level of assurance of reaching iParty's disclosure requirements and are effective in reaching that level of reasonable assurance.

(b) *Changes in Internal Controls.* No change in our internal controls 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 June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

## PART II – OTHER INFORMATION

### Item 1. Legal Proceedings

The Company is not a party to any legal proceedings expected to have a material effect on its financial position or results of operations.

### Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 30, 2006, as filed with the SEC on March 19, 2007, with the exception of those risk factors set out below:

#### *Our failure to attract, retain, and motivate qualified personnel would adversely affect our business.*

Our success depends in large part on the efforts and abilities of our senior management team. Their skills, experience and industry contacts significantly benefit our operations and administration. The failure to attract, retain, and properly motivate the members of our senior management team and other key employees, or to find suitable replacements for them in the event of death, ill health, or their desire to pursue other professional opportunities, could have a negative effect on our operating results. At the present time our President, Patrick Farrell, is transitioning his duties to other members of management in connection with his relocation to New York for personal family reasons. As previously disclosed, we envision that his regular employment with us will terminate on November 15, 2007. Our business performance and operating results will depend on our ability to successfully plan and execute this transition process.

Our performance is also largely dependent on attracting and retaining quality associates that are able to make the consumer shopping experience at our stores a fun and informative experience. We face intense competition for qualified associates, and many of our associates are in entry-level or part-time positions with historically high rates of turnover. Our ability to meet our labor needs generally while controlling our labor costs is subject to numerous external factors, including the availability of a sufficient number of qualified persons in the work force, unemployment levels, prevailing wage rates, changing demographics, health and other insurance costs and changes in employment legislation, particularly in the New England region. If we are unable to attract and retain qualified associates or our labor costs increase significantly, our business and financial performance may be adversely affected.

#### *Risks associated with recent and possible future new store openings could adversely affect our business.*

An important part of our long-range business plan is to increase our number of stores and, over time, enter new geographic markets. We have opened 15 new stores, acquired one store and closed one store over the past four years, bringing our total number of stores from 35 at the beginning of 2003 to 50 at the end of 2006. While we have no current plans for new store openings, our growth goals envision a return to opening or acquiring additional stores beginning in 2008. Also, from time to time, we have been and expect to continue to be presented with opportunities to acquire existing party supply stores. We intend to continue to evaluate such opportunities on a case-by-case basis as they may arise to ascertain if they would be a good strategic fit for our business and would help us increase shareholder value. For our growth strategy to be successful, we must identify and lease favorable store sites, hire and train associates and store managers, and adapt management and operational systems to meet the needs of our expanded operations. These tasks may be difficult to accomplish successfully. If we are unable to open new stores in locations and on terms acceptable to us as quickly as planned, our future sales and profits may be adversely affected. Even if we succeed in opening or acquiring new stores, these new stores may not achieve the same sales or profit levels as our existing stores. Also, our expansion strategy includes opening new stores in markets where we already have a presence so we can take advantage of economies of scale in marketing, distribution and supervision



costs. However, these new stores may result in the loss of sales in existing stores in nearby areas, which could adversely affect our business and financial performance. In addition, future store openings could cause us, among other things, to incur additional debt, increased interest expense, as well as experience dilution in earnings, if any, per share. Impairment losses could also occur as a result of new store openings in the event that new store openings prove unsuccessful.

*Shares that are or may be offered for sale pursuant to a prospectus on Form S-3 filed with the SEC and declared effective on April 4, 2007 or that may be eligible for sale in the future could negatively affect our stock price.*

The market price of our common stock could decline as a result of sales of a large number of shares of our common stock or the perception that these sales could occur. This may also make it more difficult for us to raise funds through the issuance of debt or the sale of equity securities.

As of June 30, 2007 there were 28,433,195 potential additional common share equivalents outstanding. These included 15,576,913 shares issuable upon the conversion of immediately convertible preferred stock, 2,083,334 shares issuable upon the exercise of a warrant with an exercise price of \$0.475, 528,210 shares issuable upon the exercise of warrants with a weighted average exercise price of \$3.79 and 10,244,738 shares issuable upon the exercise of stock options with a weighted average exercise price of \$0.59.

Our unregistered securities may be sold in the future pursuant to registration statements filed with the SEC or without registration under the Securities Act, to the extent permitted by Rule 144 or other exemptions under the Securities Act. We may issue additional shares in the future in connection with acquisitions, compensation or otherwise. We have not entered into any agreements or understanding regarding any future acquisitions not described herein and cannot ensure that we will be able to identify or complete any acquisition in the future.

## **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**

On June 6, 2007, iParty Corp. held its Annual Meeting of Stockholders. There were a total of 37,647,438 votes entitled to be cast at the meeting. Of this total, 31,719,916 or approximately 84.3% of the total number of votes eligible to be cast, were represented either in person or by proxy. At the meeting, the stockholders elected seven (7) Directors to our Board of Directors. The holder of Series C convertible preferred stock was entitled to vote alone for the election of a Series C Director. Robert Jevon was the designee of the holder of the Series C convertible preferred stock. The holder of Series D convertible preferred stock was entitled to vote alone for the election of a Series D Director. Christina W. Vest was the designee of the holder of the Series D convertible preferred stock. Set forth below are (i) the names of the persons elected to serve on iParty Corp.'s Board of Directors until the next Annual Meeting of Stockholders and until their successors are duly elected and qualified and (ii) the results of the voting for the nominees.

	Votes For		Withheld	
	Number	% of Total	Number	% of Total
<b>Directors:</b>				
Sal Perisano	30,978,066	97.7%	741,850	2.3%
Daniel DeWolf	31,524,466	99.4%	195,450	0.6%
Frank Haydu	31,528,466	99.4%	191,450	0.6%
Eric Schindler	31,524,466	99.4%	195,450	0.6%
Joseph Vassalluzzo	30,971,016	97.6%	748,900	2.4%
Robert Jevon	1,350,000	100.0%	-	0.0%
Christina W. Vest	3,500,000	100.0%	-	0.0%

The stockholders also ratified the appointment of Ernst & Young LLP as our independent public auditors for the current fiscal year ending December 29, 2007. Set forth below is the result of that vote.

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	<b>Votes For</b>		<b>Against</b>		<b>Abstain</b>	
	<b>Number</b>	<b>% of Total</b>	<b>Number</b>	<b>% of Total</b>	<b>Number</b>	<b>% of Total</b>
Ratification of Appointment of Ernst & Young LLP as our independent public auditor	31,611,681	99.7%	108,135	0.3%	100	0.0%

**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.

**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: August 2, 2007

**EXHIBIT INDEX**

<b><u>EXHIBIT NUMBER</u></b>	<b><u>DESCRIPTION</u></b>
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

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