

IPARTY CORP  
Form 10-Q  
August 13, 2012

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, 2012

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 1-15611

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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 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

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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 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   
o No

As of August 1, 2012, there were 24,418,284 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  
(unaudited)

	Jun 30, 2012	Dec 31, 2011
<b>ASSETS</b>		
Current assets:		
Cash	\$62,450	\$63,650
Restricted cash	463,236	819,604
Accounts receivable	707,685	1,377,234
Inventories	17,143,764	15,965,507
Prepaid expenses and other assets	1,554,260	1,415,780
Deferred income tax asset	46,762	46,762
Total current assets	19,978,157	19,688,537
Property and equipment, net	2,598,418	2,664,086
Intangible assets, net	466,630	626,900
Other assets	298,385	333,731
Deferred income tax asset	540,841	540,841
Total assets	\$23,882,431	\$23,854,095
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and book overdrafts	\$8,418,001	\$5,970,015
Accrued expenses	2,276,653	2,295,467
Current portion of capital lease obligations	-	4,613
Borrowings under line of credit	4,015,652	5,366,512
Total current liabilities	14,710,306	13,636,607
Long-term liabilities:		
Deferred rent	1,514,400	1,504,973
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; 419,658 and 420,408 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively	6,244,511	6,255,671
Series C convertible preferred stock - 100,000 shares authorized, issued and outstanding (aggregate liquidation value of \$2,000,000 at June 30, 2012)	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 June 30, 2012)	3,652,500	3,652,500
Series E convertible preferred stock - 533,333 shares authorized; 296,666 shares issued and outstanding (aggregate liquidation value of \$1,112,497 at June 30, 2012)	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 June 30, 2012)	500,000	500,000

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Total convertible preferred stock	13,001,508	13,012,668
Common stock - \$.001 par value; 150,000,000 shares authorized; 24,418,284 and 24,408,594 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively	24,418	24,409
Additional paid-in capital	53,098,048	52,987,574
Accumulated deficit	(58,466,249 )	(57,312,136 )
Total stockholders' equity	7,657,725	8,712,515
Total liabilities and stockholders' equity	\$23,882,431	\$23,854,095

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

iPARTY CORP.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(unaudited)

	For the three months ended		For the six months ended	
	Jun 30, 2012	Jun 25, 2011	Jun 30, 2012	Jun 25, 2011
Revenues	\$19,562,979	\$19,617,207	\$35,316,724	\$34,709,335
Operating costs:				
Cost of products sold and occupancy costs	12,052,375	11,819,894	22,078,555	21,420,765
Marketing and sales	5,732,438	5,960,011	10,943,347	11,096,753
General and administrative	1,653,941	1,729,667	3,356,317	3,515,689
Operating income (loss)	124,225	107,635	(1,061,495 )	(1,323,872 )
Change in fair value of warrant liability	(323 )	17,538	(539 )	11,316
Interest expense (net)	(42,749 )	(81,920 )	(92,079 )	(155,102 )
Income (loss) before income taxes	81,153	43,253	(1,154,113 )	(1,467,658 )
Income taxes	-	-	-	-
Net income (loss)	\$81,153	\$43,253	\$(1,154,113 )	\$(1,467,658 )
Income (loss) per share:				
Basic	\$0.00	\$0.00	\$(0.05 )	\$(0.06 )
Diluted	\$0.00	\$0.00	\$(0.05 )	\$(0.06 )
Weighted-average shares outstanding:				
Basic	38,930,281	39,301,774	24,412,507	24,355,975
Diluted	39,422,446	39,905,404	24,412,507	24,355,975

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

iPARTY CORP.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)

For the six months ended  
Jun 30, 2012      Jun 25, 2011

## Operating activities:

Net loss	\$(1,154,113 )	\$(1,467,658 )
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation	516,297	596,376
Amortization	179,064	201,034
Deferred rent	9,427	(5,954 )
Non-cash stock-based compensation expense	98,784	112,070
Loss on disposal of assets	750	1,710
Change in fair value of warrants	539	(11,316 )
Changes in operating assets and liabilities:		
Accounts receivable	669,549	(243,640 )
Inventories	(1,178,257 )	(2,710,905 )
Prepaid expenses and other assets	(121,928 )	(193,628 )
Accounts payable and book overdrafts	2,447,987	2,948,041
Accrued expenses and other liabilities	(18,814 )	17,153
Net cash (used in) provided by operating activities	1,449,285	(756,717 )

## Investing activity:

Purchase of property and equipment	(451,379 )	(659,607 )
Net cash used in investing activity	(451,379 )	(659,607 )

## Financing activities:

Net borrowings (payments) under line of credit	(1,350,860 )	1,479,664
Decrease (increase) in restricted cash	356,368	(81,830 )
Principal payments on capital lease obligations	(4,614 )	(4,613 )
Proceeds from exercise of stock options	-	24,103
Net cash (used in) provided by financing activities	(999,106 )	1,417,324

Net (decrease) increase in cash	(1,200 )	1,000
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Cash beginning of period	63,650	62,650
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Cash end of period	\$62,450	\$63,650
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## Supplemental disclosure of non-cash financing activities:

Conversion of Series B convertible preferred stock to common stock	\$11,160	\$12,053
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Disposal of property and equipment	\$46,129	\$3,360
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The accompanying notes are an integral part of these Consolidated Financial Statements.

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iPARTY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2012

(unaudited)

1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES:

Interim Financial Information

The interim consolidated financial statements as of June 30, 2012 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 31, 2011 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 31, 2011.

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 accounted for approximately 50% of the Company's purchases of merchandise for the six months ended June 30, 2012, 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, Amscan, Inc. ("Amscan") 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, excluding temporary stores, 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. The Company's purchases in 2011 exceeded the minimum purchase requirements for that year. The Company is not aware of any reason that would prevent it from meeting the minimum purchase requirements during the remaining term of the Supply Agreement.

On December 30, 2010, the Company and Amscan agreed to extend the original expiration date of the Supply Agreement from December 31, 2012 to December 31, 2013. In addition, on December 30, 2010, the Company agreed with Party City Corporation ("Party City"), an affiliate of Amscan, to take over one Party City leased location in Manchester, Connecticut on March 1, 2011. As part of the store takeover, the Company entered into an amendment to that certain Asset Purchase Agreement dated August 7, 2006 with Party City to extend the term of the non-compete provisions with Party City and its affiliates contained in the Asset Purchase Agreement from August 7, 2011 until December 31, 2013 and to include the Manchester, Connecticut location as part of the restricted area in the non-compete provisions.

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#### Accounts Receivable

Accounts receivable primarily represent amounts due from credit card companies and from 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 consolidated 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

#### Cash and Restricted Cash

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 \$2,304,280 at June 30, 2012 and \$2,000,025 at December 31, 2011.

Restricted cash represents funds on deposit established for the benefit of and under the control of Wells Fargo Bank, National Association (successor by merger to Wells Fargo Retail Finance, LLC) (“Wells Fargo”), the Company’s lender under its line of credit, and constitutes collateral for amounts outstanding under this line.

#### 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 the carrying value because the debt bears interest at a variable market rate. The fair value at June 30, 2012 of the warrants issued in 2008 was determined by using the Black-Scholes model (implied volatility of 122.34%, risk free rate of 0.21% and expected life of 0.66 years).

#### Inventories

Inventories consist of party supplies and are valued at the lower of moving weighted-average cost or market which approximates FIFO (first-in, first-out). The Company records vendor rebates, discounts and certain other adjustments to inventories, including freight costs, and these amounts are recognized in the income statement as the related goods are sold.

#### Net Income (Loss) per Share

Net income (loss) per basic share is computed by dividing net income (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 (loss) per basic share in accordance with Accounting Standards Codification (ASC) 260-10-45, Earnings Per Share – Other Presentation Matters. 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, the application of ASC 260-10-45 has no effect on the amount of net income (loss) per basic share of common stock. For periods with net losses, the Company does not allocate losses to Series B-F preferred stock.



Net income (loss) per diluted share under ASC 260-10-45 is computed by dividing net income (loss) by the weighted-average number of common shares outstanding plus, if dilutive, 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 those common share equivalents since their impact would be anti-dilutive.

The following table sets forth the computation of net income (loss) per basic and diluted share available to common stockholders:

	For the three months ended		For the six months ended	
	Jun 30, 2012	Jun 25, 2011	Jun 30, 2012	Jun 25, 2011
Common shares	\$50,898	\$26,845	\$(1,154,113 )	\$(1,467,658 )
Convertible preferred Series B-F	30,255	16,408	-	-
Net income (loss)	\$81,153	\$43,253	\$(1,154,113 )	\$(1,467,658 )
Net income (loss) per share				
Basic	\$0.00	\$0.00	\$(0.05 )	\$(0.06 )
Diluted	\$0.00	\$0.00	\$(0.05 )	\$(0.06 )
Weighted-average shares outstanding:				
Common shares - basic	24,416,420	24,392,486	24,412,507	24,355,975
Common share equivalents of Series B-F convertible preferred stock	14,513,861	14,909,288	-	-
If - converted weighted-average shares outstanding	38,930,281	39,301,774	24,412,507	24,355,975
Common share equivalents of "in the money" stock options	492,165	603,630	-	-
Common share equivalents of "in the money" warrants	-	-	-	-
Diluted weighted-average shares outstanding	39,422,446	39,905,404	24,412,507	24,355,975

The common stock equivalents of Series B-F preferred stock calculated on an if converted basis totaled 14,517,774 and 14,913,670 shares for the six months ended June 30, 2012 and June 25, 2011, respectively. These share amounts have been excluded from net loss per share since their impact would have been anti-dilutive.

The common share equivalents of “out of the money” stock options and warrants which were also excluded from the computation of net income per diluted share available to common stockholders were 5,823,837 and 100,000 in the second quarter of 2012, and 5,584,016 and 2,183,334 in the second quarter of 2011, respectively.

#### Stock-Based 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.

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The stock-based compensation expense recognized by the Company was:

	For the three months ended		For the six months ended	
	Jun 30, 2012	Jun 25, 2011	Jun 30, 2012	Jun 25, 2011
Stock-based compensation expense	\$50,082	\$67,398	\$98,784	\$112,070

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 six months ended June 30, 2012 or June 25, 2011.

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 no longer grants 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 for shares under its Plans, which have been granted to employees, directors and consultants of the Company at fair market value at the date of grant. Of the options that have been issued, options for 1,548,751 shares have been exercised and options for 7,809,270 shares remain outstanding at June 30, 2012. Generally, employee options become exercisable over periods of up to four years, and expire ten years from the date of grant.

At the annual Board of Directors meeting following the Company's stockholders meeting in 2012, the Company granted options to its independent directors for the purchase of 120,000 shares of common stock at an exercise price of \$0.20 per share. At the annual Board of Directors meetings following the Company's annual stockholders meetings in 2011 and 2010, the Company granted options to its key employees, including its CEO and CFO, and independent directors in the following total amounts: (i) 817,100 options for the purchase of shares of common stock on June 10, 2011 at an exercise price of \$0.28 per share, and (ii) 502,320 options for the purchase of shares of common stock on June 2, 2010 at an exercise price of \$0.30 per share. Also, the Company granted options for the purchase of an aggregate of (i) 633,400 shares of common stock to key employees on January 18, 2012 at an exercise price of \$0.14 per share, and (ii) 165,000 shares of common stock to key employees on March 11, 2010 at an exercise price of \$0.41 per share. The fair values using the Black-Scholes option pricing model of the options granted were as follows: June 6, 2012, \$0.17 per share; January 18, 2012, \$0.12 per share; June 10, 2011, \$0.23 per share; June 2, 2010, \$0.25 per share; and March 11, 2010, \$0.34 per share. The exercise price for each of the option grants made in 2010, 2011 and 2012 was equal to the grant date closing price of the Company's common stock as reported on the NYSE Amex.

On April 1, 2010, in accordance with the related provisions of new employment contracts executed as of that date, options to purchase 720,000 shares of common stock granted on May 27, 2009 to the Company's Chief Executive Officer and Senior Vice President – Merchandising and Marketing were accelerated and became fully vested. The acceleration of the options resulted in immediate recognition of expense in the amount of \$48,204. In addition, on July 1, 2010, the Company granted options for the purchase of 675,000 shares of common stock to these two executives, pursuant to their new employment contracts, at an exercise price of \$0.27 per share. One third of each of these executives' options vested on July 1, 2010, the grant date, with the remaining options vesting as to one third on each of the next two grant date anniversaries. The fair value using the Black-Scholes option pricing model of the July 1, 2010

executive options was \$0.22 per share.

At the date of the grant, the weighted average fair value of the options at the date of the grant for options granted during the six months ended June 30, 2012 and June 25, 2011 was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

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	For the three months ended				For the six months ended			
	Jun 30, 2012		Jun 25, 2011		Jun 30, 2012		Jun 25, 2011	
Risk-free interest rate	0.79	%	0.76	%	0.82	%	0.76	%
Expected volatility	124.41	%	114.23	%	114.69	%	114.23	%
Weighted average expected life (in years)	5.31		5.27		6.62		5.27	
Expected dividends	0.00	%	0.00	%	0.00	%	0.00	%

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

	Number of Stock Options	Weighted Average Exercise Price	Price Range	Weighted Average Remaining Life (Years)	Aggregate Intrinsic Value
Outstanding - December 31, 2011	7,542,459	0.41	0.07 - 1.33	-	
Granted	753,400	0.15	0.14 - 0.20	-	
Expired	(483,896 )	0.33	0.30 - 1.06	-	
Forfeited	(2,693 )	0.30	0.30 - 0.30	-	
Exercised	-	-	- - -	-	
Outstanding - June 30, 2012	7,809,270	0.39	0.07 - 1.33	5.81	221,127
Exercisable - June 30, 2012	6,177,948	0.44	0.07 - 1.33	5.02	155,699
Available for grant - June 30, 2012	1,641,979				

The following table summarizes information for options outstanding and exercisable at June 30, 2012:

Price Range	Number of Stock Options	Outstanding		Exercisable	
		Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Stock Options	Weighted Average Exercise Price
\$ 0.07 - \$ 0.20	2,038,760	7.8	\$ 0.12	1,279,659	\$ 0.11
0.21 - 0.30	2,180,032	8.1	0.28	1,380,036	0.28
0.31 - 0.50	1,794,070	4.5	0.41	1,721,845	0.41
0.51 - 1.00	1,763,408	2.1	0.81	1,763,408	0.81
1.01 - 1.33	33,000	1.5	1.13	33,000	1.13
Total	7,809,270	5.8	\$ 0.39	6,177,948	\$ 0.44

The remaining unrecognized stock-based compensation expense related to unvested awards at June 30, 2012 was \$248,695 and the period of time over which this expense will be recognized is 2.6 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
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 (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 and its affiliates, originally covered Massachusetts, Maine, New Hampshire, Vermont, Rhode Island, and Windsor and New London counties in Connecticut, and was to expire in 2011. This non-compete agreement had an original estimated life of 60 months. On December 30, 2010, the Company executed an agreement with Party City to take over its leased location in Manchester, Connecticut. Under that agreement, the term of this non-compete agreement was extended to December 31, 2013 and the non-compete area was amended to include a three mile radius around the Manchester, Connecticut store.

The other 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. This non-compete agreement 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. Other than Rhode Island, the New England non-compete under this agreement has expired. This non-compete agreement has an estimated life of 60 months. Both non-compete agreements 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 as of June 30, 2012 and December 31, 2011 were:

	Jun 30, 2012	Dec 31, 2011
Non-compete agreements	\$ 2,358,540	\$ 2,358,540
Occupancy valuations	944,716	944,716
Other	157,855	157,855
<b>Intangible assets</b>	<b>3,461,111</b>	<b>3,461,111</b>
<b>Less: accumulated amortization</b>	<b>(2,994,481 )</b>	<b>(2,834,211 )</b>

Intangible assets, net	\$ 466,630	\$ 626,900
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Amortization expense for these intangible assets was:

	For the three months ended		For the six months ended	
	Jun 30, 2012	Jun 25, 2011	Jun 30, 2012	Jun 25, 2011
Amortization expense	\$ 80,136	\$ 79,202	\$ 160,271	\$ 158,405

Non-compete agreements are amortized based on the pattern of their expected cash flow benefits over the terms of the agreements. As a consequence of the December 30, 2010 amendment of the Party City non-compete agreement, the remaining unamortized asset associated with that agreement is being amortized over its remaining term, as amended. Occupancy valuations are amortized on a straight line basis over the terms of the related leases ranging from 79 to 96 months. The non-compete agreement amortization expense is included in general and administrative expense on the Consolidated Statements of Operations. The occupancy valuation amortization expense is included in cost of products sold and occupancy costs.

Future amortization expense related to these intangible assets as of June 30, 2012 is:

Year	Amount
2012	\$ 160,271
2013	208,761
2014	59,848
2015	37,750
Total	\$ 466,630

#### 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 fourth quarter of the Company's fiscal year ended December 31, 2011, the Company determined that one of its retail stores was impaired due to underperforming sales. As a result of this impairment, a charge of approximately \$26,000 was recorded to reduce to fair value (\$0) the remaining carrying value of the property and equipment utilized in this store. The Company is not aware of any impairment indicators for any of our other stores at June 30, 2012.

#### Line of Credit

On October 14, 2011, the Company and its wholly owned subsidiary, as borrowers, entered into the First Amendment (the "Amendment") to the Second Amended and Restated Credit Agreement by and among the Company, its wholly owned subsidiary, and Wells Fargo Bank, National Association, as administrative agent and collateral agent, (the "Facility"). The Amendment continues the Facility in the amount of up to \$12,500,000 and extends the maturity date of the Facility to October 14, 2016. The Facility also allows the Company to increase the Facility up to a maximum level of \$15,000,000. The amount of credit that is available from time to time under the Facility continues to be determined as a percentage of the value of eligible inventory plus a percentage of the value of eligible credit card receivables, reduced by certain reserve amounts that may be required by Wells Fargo.

The Facility, as amended, provides for interest of 0.25% above Wells Fargo's base rate, or, at the Company's election, 2.00% above the London Interbank Offered Rate ("LIBOR"). The Facility also provides for letters of credit for up to a sublimit of \$2 million to be used in connection with inventory purchases. The obligations of the Company under the Facility are secured by a lien on substantially all its personal property.



The Facility contains a number of restrictive covenants, such as incurrence, payment or entry into certain indebtedness, liens, investments, acquisitions, mergers, dispositions and dividends. The Facility 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 Facility may be accelerated, outstanding letters of credit may be required to be cash collateralized and Wells Fargo may exercise remedies to collect the balance due, including to foreclose on the collateral.

The Facility includes a financial covenant requiring the Company to maintain a minimum availability under the line of 7.5% of the credit limit, except for the period from January 1, 2012 through April 30, 2012, during which period the minimum availability was zero. The 7.5% limit was restored on May 1, 2012 to \$937,500 based on the Facility's credit limit of \$12,500,000. The Facility also has a covenant that requires the Company to limit its capital expenditures to within 110% of those amounts included in its business plan, which may be updated from time to time. As of June 30, 2012 and as of December 31, 2011, the Company was in compliance with all debt covenants. The Agreement also includes a 0.375% unused line fee. The line generally prohibits the payment of any dividends or other distributions to any of the Company's classes of capital stock.

The amounts outstanding under the Facility as of June 30, 2012 and December 31, 2011 were \$4,015,652 and \$5,366,512, respectively. The interest rate on these borrowings was 2.72% at June 30, 2012 and 2.80% at December 31, 2011. The outstanding balances under the Facility are classified as current liabilities in the accompanying consolidated balance sheets since the Company is required to apply daily lock box receipts to reduce the amount outstanding. At June 30, 2012, the Company had \$5,889,228 of additional availability under the Facility.

#### Stockholders' Equity

Upon the expiration of the Highbridge Warrant on September 15, 2011, the conversion prices of the Series B, C, and D convertible preferred stock were recomputed to reflect the reversal of the anti-dilution adjustment calculated at the warrant's issuance in 2006. As a result, the outstanding shares of these three series of preferred stock are now convertible into approximately 385,514 fewer shares of common stock. The expiration of the Highbridge Warrant had no impact on the Series E or F convertible preferred stock or any of the other outstanding warrants.

#### Fair Value Measurements

The Company follows the provisions of ASC 820, Fair Value Measurements and Disclosures. ASC 820 defines 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 describes 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 June 30, 2012 and December 31, 2011 are cash and restricted cash which are based on Level 1 inputs and the warrant liability which is based on Level 2 inputs.



### Income taxes

The Company has not provided for income taxes for the second quarter of fiscal 2012 or fiscal 2011 due to the availability of net operating loss (NOL) carryforwards to eliminate federal taxable income on an annual basis, and uncertainty of state taxable income based on the extent of our operating loss through June 30, 2012. No benefit has been recognized with respect to current losses or NOL carryforwards in these periods due to the uncertainty of future taxable income beyond 2012, the assessment of which depends largely on our operating results during our fourth quarter. We continue to believe we will be able to realize the deferred tax asset of \$587,603 based on estimated 2012 taxable income.

At the end of 2011, the Company had estimated net operating loss carryforwards of approximately \$16.6 million, which begin to expire in 2020. In accordance with Section 382 of the Internal Revenue Code, the use of these carryforwards may be subject to annual limitations based upon certain ownership changes of the Company's stock that may have occurred or that may occur.

### New Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2012-02, Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment ("ASU 2012-02"). ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is allowed, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The adoption of this update is not expected to have any effect on the Company's consolidated financial statements.

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### SUBSEQUENT EVENTS

On July 11, 2012, the Company announced the signing of leases for two new stores in the Greater Boston area. The first of these stores will be located in Plaistow, New Hampshire, and the second will be located in Waltham, Massachusetts. The Company expects to open these stores before the 2012 Halloween season.



## 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 31, 2011.

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 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 our 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 our most recently filed Annual Report on Form 10-K for the fiscal year ended December 31, 2011 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 party goods retailer operating stores throughout New England, where 47 of our 52 retail stores are located, and in Florida in addition to an online e-commerce site. In June and July of 2012, we signed leases for two additional locations in the Greater Boston area, which are scheduled to open in time for the 2012 Halloween season. When these stores are opened, we will have 54 retail stores. We believe we are a leading brand in the party industry in the retail markets we serve and a leading resource in those markets for consumers seeking party goods, party planning advice and information.

Our 52 retail stores are located predominantly in New England with 7 stores in Connecticut, 6 in New Hampshire, 3 in Rhode Island, 3 in Maine, 1 in Vermont, and 27 in Massachusetts. We also operate 5 stores in Florida. In July 2011, we re-launched our newly redesigned e-commerce site with a full assortment of costume and related merchandise for purchase and shipping via the internet. In the second quarter of 2012, we added adult birthday and additional seasonal and basic items merchandise to the e-commerce site. We plan to continue to expand our e-commerce offerings with additional offerings during the remainder of 2012. We also use our internet site to highlight the changing store product assortment and feature sales flyers, promotions and coupons to increase customer visits to our retail stores.

During the 2011 Halloween season, we operated eleven temporary stores, the same number of temporary stores operated during the 2010 Halloween season. In December 2010, we opened a new store in the South Bay Center, Boston, Massachusetts and entered into an agreement to take over an additional store from a competitor in Manchester, Connecticut in the first quarter of 2011, which opened in March 2011. In January 2012, we reopened our store in West Lebanon, New Hampshire, which had been closed due to flood damage since August 2011, and we closed our older store in Manchester, Connecticut.

Our stores range in size from approximately 7,000 square feet to 20,295 square feet and average approximately 10,299 square feet in size.

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We lease our properties, typically for 10 years and usually with options from our landlords to extend 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 six months ended	
	Jun 30, 2012	Jun 25, 2011
Beginning of period	52	52
Openings / Acquisitions	1	1
Closings	(1 )	-
End of period	52	53

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 primarily driven by the following holiday and party events: Halloween, Christmas, Easter, Valentine's Day, New Year's, Independence Day, St. Patrick's Day, Thanksgiving, Chanukah and sports championships. We also focus our business closely on lifetime events such as anniversaries, graduations, birthdays, and bridal and baby showers.

#### Trends and Quarterly Summary

Our business has a seasonal pattern. In the past three years, we have realized an average of approximately 36.2% of our annual revenues in our fourth quarter, which includes Halloween and Christmas, and an average of approximately 24.6% of our revenues in the second quarter, which includes school graduations, and often the Easter holiday. Also, during these past three years, we have had net income in our second and fourth quarters and generated losses in our first and third quarters.

#### Second Quarter Summary

For the second quarter of 2012, our consolidated revenues were \$19.56 million, compared to \$19.62 million for the second quarter of 2011. The decrease in consolidated revenue was driven by the sales results from our Manchester, Connecticut market, which was consolidated from two stores in the second quarter of 2011 to one store in the second quarter of 2012. The new Manchester store delivered significantly higher contribution in Q2 2012 than the combined stores in Q2 2011, but on a lower sales base. In the second quarter of 2012, our comparable store sales (sales from stores open more than one year) increased slightly by 0.1% compared to the second quarter of 2011. Consolidated gross profit margin was 38.4% for the second quarter of 2012, compared to a gross profit margin of 39.7% for the same period in 2011. The gross profit margin components included a decrease of 1.0% in product selling margin rate, the result of earlier and deeper clearance markdowns in 2012 compared to 2011. The consolidated net income for the second quarter of 2012 was \$81 thousand, or \$0.00 per share, compared to \$43 thousand, or \$0.00 per share, for the second quarter of 2011.

#### Acquisition and Growth Strategy

Our growth strategy for 2012 and beyond includes expanding and targeting the temporary Halloween store aspect of our business, opening new stores, relocating or consolidating existing stores, reviewing potential acquisition of other entities, and developing our e-commerce site. As part of this growth strategy, in July 2012, we announced the planned opening of two new stores in the Greater Boston area. In March 2011, we took over a competitor's Manchester, Connecticut store. In addition, we opened eleven temporary Halloween stores in 2011. Any determination whether to open a new or temporary store or make an acquisition is based upon a variety of factors, including, without limitation, the purchase price and other financial terms of the transaction, our liquidity and ability to finance the transaction, the

business prospects, geographical location and the extent to which any new or temporary store or acquisition would enhance our business.

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## Results of Operations

Fiscal year 2012 has 52 weeks and ends on December 29, 2012. Fiscal year 2011 had 53 weeks and ended on December 31, 2011.

The second quarter of fiscal year 2012 had 13 weeks and ended on June 30, 2012. The second quarter of fiscal year 2011 had 13 weeks and ended on June 25, 2011.

## Three Months Ended June 30, 2012 Compared to Three Months Ended June 25, 2011

## Revenues

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale or at the time of shipment for internet sales. Our consolidated revenues for the second quarter of fiscal 2012 were \$19,562,979, a decrease of \$54,228, or 0.3% from the second quarter of the prior fiscal year, and included an increase in comparable store sales of 0.1% for the quarter. The decrease in total sales was primarily due to the sales results from our Manchester, Connecticut market, which was consolidated from two stores in the second quarter of 2011 to one store in the second quarter of 2012. The new Manchester store delivered a significantly higher contribution in Q2 2012 than the combined stores in Q2 2011, but on a lower sales base.

	For the three months ended			
	Jun 30, 2012		Jun 25, 2011	
Revenues	\$	19,562,979	\$	19,617,207
Increase (decrease) in revenues		-0.3	%	-2.2
				%

## 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 2012 were \$12,052,375 or 61.6% of revenues, an increase of \$232,481, or 1.3% as a percentage of revenues, compared to the second quarter of the prior fiscal year.

	For the three months ended			
	Jun 30, 2012		Jun 25, 2011	
Cost of products sold and occupancy costs	\$	12,052,375	\$	11,819,894
Percentage of revenues		61.6	%	60.3
				%

As a percentage of revenues, cost of products sold and occupancy costs included a decrease in product selling margins of 1.0% and an increase in occupancy costs of 0.3% as a percentage of revenues. The decline in selling margin was caused by accelerated clearance markdowns in the second quarter of 2012 compared to 2011. The increase in occupancy costs was mainly due to increases in common area maintenance charges in 2012 compared to 2011.

## 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 2012 was \$5,732,438, or 29.3% of revenues, a decrease of \$227,573 and a decrease of 1.1 percentage points, as a percentage of revenues, from the second quarter of the prior fiscal year. The decrease in marketing and sales expense was primarily due to a decrease in payroll costs in our stores in the second quarter of 2012 compared to the second quarter of 2011.

	For the three months ended			
	Jun 30, 2012		Jun 25, 2011	
Marketing and sales	\$	5,732,438	\$	5,960,011
Percentage of revenues		29.3	%	30.4
				%

## 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 2012 was \$1,653,941 or 8.5% of revenues, a decrease of \$75,726 or 0.3 percentage points, as a percentage of revenues, from the second quarter of the prior fiscal year. The decrease in general and administrative expense was primarily due to lower professional fees in the second quarter of 2012 compared to the second quarter of 2011.

	For the three months ended			
	Jun 30, 2012		Jun 25, 2011	
General and administrative	\$	1,653,941	\$	1,729,667
Percentage of revenues		8.5	%	8.8
				%

## Operating income

Our operating income for the second quarter of fiscal 2012 was \$124,225, or 0.6% of revenues, as compared to \$107,635, or 0.5% of revenues for the second quarter of the prior fiscal year.

## Interest expense

Our interest expense in the second quarter of fiscal 2012, net of interest income, was \$42,749, a decrease of \$39,171 from the second quarter of the prior fiscal year. The decrease in the second quarter of fiscal 2012 as compared to the prior period was due to lower effective interest rates in the second quarter of 2012 compared to the same period in 2011.

## Income taxes

We have not provided for income taxes for the second quarter of fiscal 2012 or fiscal 2011 due to the availability of net operating loss (NOL) carryforwards to eliminate federal taxable income on an annual basis, and uncertainty of state taxable income based on the extent of our operating loss through June 30, 2012. No benefit has been recognized with respect to current losses or NOL carryforwards in these periods due to the uncertainty of future taxable income beyond 2012, the assessment of which depends largely on our operating results during our fourth quarter. We

continue to believe we will be able to realize the deferred tax asset of \$587,603 based on estimated 2012 taxable income.

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At the end of 2011, we had estimated net operating loss carryforwards of approximately \$16.6 million, which begin to expire in 2020. In accordance with Section 382 of the Internal Revenue Code, the use of these carryforwards may be subject to annual limitations based upon certain ownership changes of our stock that may have occurred or that may occur.

#### Net loss

Our net income in the second quarter of fiscal 2012 improved to \$81,153 compared to \$43,253 in the second quarter of the prior fiscal year. On a per share basis, both second quarter 2012 and 2011 were \$0.00 per basic and diluted share.

#### Six months Ended June 30, 2012 Compared to Six months Ended June 25, 2011

#### 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 2012 were \$35,316,724, an increase of \$607,389, or 1.7% from the first six months of the prior fiscal year. The increase was primarily due to increased sales in our comparable stores of 3.7% in the first half of 2012 compared to the first half of 2011. The largest components of the increase in comparable store sales included approximately \$678,000 in the fall, bulk and everyday categories and \$197,000 in masquerade. The increase in fall and bulk sales came largely from sales related to the 2012 Super Bowl event in the first quarter of 2012.

	For the six months ended			
	Jun 30, 2012	Jun 25, 2011		
Revenues	\$ 35,316,724	\$ 34,709,335		
Increase (decrease) in revenues	1.7	%	-0.5	%

#### 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 six months of fiscal 2012 were \$22,078,555, or 62.5% of revenues, an increase of \$657,790 from the first six months of the prior fiscal year.

	For the six months ended			
	Jun 30, 2012	Jun 25, 2011		
Cost of products sold and occupancy costs	\$ 22,078,555	\$ 21,420,765		
Percentage of revenues	62.5	%	61.7	%

As a percentage of revenues, cost of products sold and occupancy costs were 0.8 percentage points higher in the first six months of 2012 compared to the first six months of 2011, mainly due to the effect of deeper clearance markdowns in the second quarter of 2012 compared to 2011.

#### 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 2012 was \$10,943,347, or 31.0% of revenues, a decrease of \$153,406 or 1.0 percentage point, as a percentage of revenues, from the first six months of the prior fiscal year.

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	For the six months ended			
	Jun 30, 2012		Jun 25, 2011	
Marketing and sales	\$	10,943,347	\$	11,096,753
Percentage of revenues		31.0	%	32.0
				%

As a percentage of revenues, the decrease in marketing and sales expense was due to decreased payroll expense in the stores, partly offset by increases in advertising expenditures and web related payroll.

#### 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 2012 was \$3,356,317, or 9.5% of revenues, a decrease of \$159,372 from the first six months of the prior fiscal year.

	For the six months ended			
	Jun 30, 2012		Jun 25, 2011	
General and administrative	\$	3,356,317	\$	3,515,689
Percentage of revenues		9.5	%	10.1
				%

The decrease in general and administrative expense was primarily due to a decrease in professional fees, including accounting fees, board compensation expense and banking related fees.

#### Operating loss

Our operating loss for the first six months of fiscal 2012 was \$1,061,495, or 3.0% of revenues, as compared to an operating loss of \$1,323,872, or 3.8% of revenues for the first six months of the prior fiscal year.

#### Interest expense

Our interest expense in the first six months of fiscal 2012, net of interest income, was \$92,079, a decrease of \$63,023 from the first six months of the prior fiscal year. The decrease in the first six months of fiscal 2012 as compared to the prior period was due to lower effective interest rates in the first six months of 2012 compared to the same period in 2011.

#### Income taxes

We have not provided for income taxes for the first six months of fiscal 2012 or fiscal 2011 due to losses in the six month period ended June 30, 2012 and in the six month period ended June 25, 2011 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 in these periods due to the uncertainty of future taxable income beyond 2011, the assessment of which depends largely on our operating results during our fourth quarter. We continue to believe we will be able to realize the deferred tax asset of \$587,603 based on estimated 2012 taxable income.

At the end of 2011, we had estimated federal net operating loss carryforwards of approximately \$16.6 million, which begin to expire in 2020. In accordance with Section 382 of the Internal Revenue Code, the use of these carryforwards

may be subject to annual limitations based upon certain ownership changes of our stock that may have occurred or that may occur.

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## Net loss

Our net loss in the first six months of fiscal 2012 was \$1,154,113, or \$0.05 per basic and diluted share, compared to a net loss of \$1,467,658, or \$0.06 per basic and diluted share, in the first six months of the prior fiscal year.

## 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 and temporary store openings, including acquisitions.

Our primary sources of cash are:

cash from operating activities; and  
debt, including our Facility.

Our prospective cash flows are subject to certain trends, events and uncertainties, including demands for capital to support growth, including store acquisitions and openings and our e-commerce site, finance inventory purchases, 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 will be sufficient to fund our operations, working capital requirements 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, declines in consumer confidence and spending, or other unforeseen circumstances, our liquidity may be negatively impacted. If so, we could be required to adjust our expenditures for the remainder of 2012 to conserve working capital or raise additional capital, possibly including debt or equity financing to fund operations and our business strategy. Given the current state of the debt and equity markets and our existing capital structure, this could be difficult and expensive, and we might not be able to do so on terms acceptable to us.

## Line of Credit

On October 14, 2011, we entered into the First Amendment (“Amendment”) to the Second Amended and Restated Credit Agreement (the “Facility”) with Wells Fargo. The Facility continues the previous revolving line of credit in the amount of up to \$12,500,000 and extends the maturity date for five years to October 14, 2016. The Facility includes an option whereby we may increase the revolving line of credit up to a maximum level of \$15,000,000. The amount of credit that is available from time to time under the Facility 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 Facility will generally accrue interest at a margin of 0.25% over a base rate determined by Wells Fargo from time to time, or, at our election, 2.00% over LIBOR. The Facility 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 Facility. Our obligations under the Facility are secured by a lien on substantially all of our personal property.

The outstanding balances under the Facility 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.

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The Facility 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 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.

Our inventory consists of party supplies which are valued at the lower of weighted-average cost or market, which approximates FIFO (first-in, first-out) and are reduced or increased by adjustments including vendor rebates and discounts and freight costs. Our Facility availability calculation allows us to borrow against “acceptable inventory at cost”, which is based on our inventory at cost and applies adjustments that Wells Fargo 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 \$17,846,501 at June 30, 2012.

Our accounts receivable consist primarily of credit card receivables and vendor rebates receivable. Our Facility 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 \$336,524 at June 30, 2012.

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, 2012. Under the terms of the Facility, 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 the Facility were \$4,015,652 at June 30, 2012 and \$5,366,512 at December 31, 2011, a decrease of \$1,350,860. Our additional availability was \$5,889,228 at June 30, 2012 and \$3,129,457 at December 31, 2011.

The Facility has financial covenants that include maintaining a minimum availability and limiting 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 Facility, we are required to maintain a minimum availability of 7.5% of the credit limit, except for the period January 1, 2012 through April 30, 2012, during which time the minimum availability was zero. The Facility also 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, 2012, we were in compliance with these financial covenants.

#### Supply Agreement with Amscan

Our Supply Agreement with Amscan gives us the right to receive more favorable pricing terms over the term of the Supply Agreement than generally were available to us under our previous terms with Amscan. In exchange, the Supply Agreement obligates us to purchase increased levels of merchandise from Amscan. 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, excluding temporary stores, open during such calendar year, multiplied by \$180,000. The Supply Agreement extends until December 31, 2013.

The Supply Agreement provides for penalties in the event we fail to attain the annual purchase commitment that would require us to pay 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 Amscan. Our purchases for 2011 exceeded the minimum purchase amount commitments. We are not aware of any reason that would prevent us from meeting the

minimum purchase requirements for the remainder of 2012 or for 2013. 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.

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## Operating, Investing and Financing Activities

Our operating activities provided cash of \$1,449,285 during the six months ended June 30, 2012 compared to using \$756,717 during the six months ended June 30, 2011, an increase in cash provided of \$2,206,002. The increase in cash provided in operating activities was primarily due to a reduction of inventory purchases and a decrease in net loss for the six months ended June 30, 2012 compared to the same period in 2011, plus a reduction in credit card accounts receivable from December 31, 2011 to June 30, 2012.

We used \$451,379 in investing activity during the first six months of 2012 compared to \$659,607 during the first six months of 2011, a decrease of \$208,228. The cash invested in 2012 was primarily for improvement to our retail stores and point of sale register updates. The cash invested in 2011 was primarily for fixtures and equipment for our new Manchester, Connecticut store as well as existing store improvements.

Financing activities used \$999,106 during the first six months of 2012 compared to providing \$1,417,324 during the first six months of 2011, a decrease of \$2,416,430. The decrease was primarily due to a decreased net borrowings on the line of credit during the first six months of 2012 compared to the first six months of 2011.

## Contractual Obligations

Contractual obligations at June 30, 2012 were as follows:

	Within 1 Year	Within 2 - 3 Years	Within 4 - 5 Years	After 5 Years	Total
Line of credit	\$4,018,814	\$-	\$-	\$-	\$4,018,814
Supply agreement	8,929,868	4,680,000	-	-	13,609,868
Operating leases (including retail space leases)	9,771,091	15,660,697	10,219,915	7,988,555	43,640,258
Total contractual obligations	\$22,719,773	\$20,340,697	\$10,219,915	\$7,988,555	\$61,268,940

In addition, at June 30, 2012, we had outstanding purchase orders totaling approximately \$8,792,504 for the acquisition of inventory and non-inventory items that were scheduled for delivery after June 30, 2012.

## Seasonality

Due to the seasonality of our business, sales and operating income are typically higher in the 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 and at a profit in the second and fourth quarters.

## Geographic Concentration

As of June 30, 2012, we operated a total of 52 stores, 47 of which are located in New England and 5 of which are located in Florida. 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 our freight costs, consumer confidence and spending patterns. Additionally, we have seen shortages in helium supplies affecting the pricing of certain products, such as balloons. These and other issues directly or indirectly affecting our vendors, our customers and us could adversely affect our business and financial performance.

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#### Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that has or is 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 is 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 31, 2011, and Part II, Item 1A, "Risk Factors" contained in our Quarterly Reports on Form 10-Q, including this one, and in our other 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.

#### 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 31, 2011 included in Item 8 of our Annual Report on Form 10-K for that fiscal year, as filed with the SEC on March 28, 2012). 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

Our inventories consist of party supplies and are valued at the lower of moving weighted-average cost or market which approximates FIFO (first-in, first-out). 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 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 2011 included a reduction of \$92,908 to the cost of products sold during the previous three quarters.

#### 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.

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## 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 and its affiliates, covers Massachusetts, Maine, New Hampshire, Vermont, Rhode Island, and Windsor and New London counties in Connecticut. This non-compete agreement had an original estimated life of 60 months. The expiration date of this non-compete agreement was extended from August 7, 2011 to December 31, 2013 in conjunction with our agreement with Party City to take over their location in Manchester, Connecticut. In addition, the restricted trade area under the non-compete agreement was amended to include the trade area around the Manchester, Connecticut location.

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. This non-compete agreement 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. Other than Rhode Island, the New England non-compete under this agreement has expired. This non-compete agreement has an estimated life of 60 months. Both non-compete agreements are subject to certain terms and conditions in their respective acquisition agreements.

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).

Non-compete agreements are amortized based on the pattern of their expected cash flow benefits. Occupancy valuations are amortized on a straight line basis 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. During the fourth quarter of 2011, we determined that one of our retail stores was impaired due to underperforming sales. As a result of this impairment, we recorded a charge of approximately \$26,000 to reduce to fair value the carrying value of the property and equipment utilized in this store. We are not aware of any impairment indicators for any of our other stores at June 30, 2012.

## 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 2010, 2009, 2007 and 2006, (2) we have achieved positive comparable store sales growth for six out of the last nine years, (3) we were able to significantly reduce store and headquarters operating expenses in 2009, and (4) we were able to use federal net operating loss deductions in each tax year from 2002 through 2010. The negative evidence that we considered included (1) we realized a net loss in 2005, 2008 and 2011, (2) our merchandise margins decreased in 2010, 2009, 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 \$16.6 million at December 31, 2011, (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 the costs of opening or acquiring new stores will put pressure on our profit margins until these stores reach maturity, (5) the expected increasing costs of regulatory compliance will likely have a negative impact on our profitability, and (6) the risk that a continued, general or perceived slowdown in the U.S economy, or uncertainty as to the economic outlook, which the U.S. and world economies have recently experienced, could continue to reduce discretionary spending or cause a shift in consumer discretionary spending to other products.

The positive evidence was strong enough for us to conclude at the end of fiscal 2011 and as of June 30, 2012 that we will realize sufficient levels of taxable income in 2012 and beyond to support the net deferred tax asset value of approximately \$587 thousand. However, we believe that it is prudent for us to maintain a valuation allowance against our remaining deferred tax assets until we have a longer history 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 we made such a determination.

#### Stock Option Compensation Expense

We use the Black-Scholes option pricing model to determine the fair value of stock-based compensation. The Black-Scholes model requires us 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 our common stock price over the expected term, which is based on historical volatility of our 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 our common stock, which is assumed to be zero since we do not pay dividends and have 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. We recognize stock based compensation expense on a straight-line basis over the vesting period of each grant.

#### 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 July 2012, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2012-02, Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment (“ASU 2012-02”). ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is allowed, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity’s financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The adoption of this update is not expected to have any effect on our consolidated financial statements.

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 31, 2011, which was filed with the SEC on March 28, 2012.

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, 2012, 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 June 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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 31, 2011, as filed with the SEC on March 28, 2012.

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

Not applicable

Item 3. Defaults upon Senior Securities

Not applicable

Item 4. Mine Safety Control

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.



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 13, 2012

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION
Ex. 10.1	Compensation Arrangements with Independent Directors*
Ex. 10.2	Written Summary of Renewed One Year Part Time Consulting Arrangement with Mr. Vassalluzzo*
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
Ex. 101.INS	XBRL Instance Document**
Ex. 101.SCH	XBRL Taxonomy Extension Schema Document**
Ex. 101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document**
Ex. 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document**
Ex. 101.LAB	XBRL Taxonomy Extension Label Linkbase Document**
Ex. 101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document**

\* Management contract or compensatory plan or arrangement.

\*\*In accordance with Regulation S-T, XBRL (Extensible Business Reporting Language) related information in Exhibit No. (101) to this Quarterly Report on Form 10-Q shall be deemed “furnished” and not “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of that section, and shall not be incorporated by reference into any registration statement pursuant to the Securities Act of 1933, as amended.