IPARTY CORP
Form 10-Q
May 23, 2013

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

FORM 10-Q

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

For the Quarterly Period Ended March 30, 2013

OR

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

For the Transition Period from _______________ to _______________

Commission File Number 1-15611

iPARTY CORP.
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	76-0547750 (I.R.S. Employer Identification No.)
270 Bridge Street, Suite 301, Dedham, Massachusetts (Address of Principal Executive Offices)	02026 (Zip Code)

(781) 329-3952
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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 þ No o

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 o	Accelerated filer o
Non-accelerated filer o (Do not check if smaller reporting company)	Smaller reporting company þ

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

As of May 10, 2013 there were 100 shares of common stock, $.01 par value, outstanding.

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

Item 1. Financial Statements

iPARTY CORP.
CONSOLIDATED BALANCE SHEETS
(unaudited)

	Mar 30, 2013	Dec 29, 2012
ASSETS		
Current assets:		
Cash	$64,250	$64,650
Restricted cash	577,756	480,816
Accounts receivable	764,108	821,903
Inventories	18,094,388	17,004,269
Prepaid expenses and other assets	1,622,601	1,646,950
Total current assets	21,123,103	20,018,588
Property and equipment, net	2,508,582	2,693,991
Intangible assets, net	276,183	327,329
Other assets	270,492	282,878
Total assets	$24,178,360	$23,322,786
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and book overdrafts	$7,301,522	$6,829,864
Accrued expenses	2,359,386	1,870,906
Borrowings under line of credit	7,571,616	5,764,312
Total current liabilities	17,232,524	14,465,082
Long-term liabilities:		
Deferred rent	1,513,449	1,507,732
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; 418,658 and 418,658 shares issued and outstanding at March 30, 2013 and December 29, 2012, respectively (aggregate liquidation value of $8,393,160 at March 30, 2013)	6,229,631	6,229,631
Series C convertible preferred stock - 100,000 shares authorized, issued and outstanding (aggregate liquidation value of $2,000,000 at March 30, 2013)	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 March 30, 2013)	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 March 30, 2013)	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 March 30, 2013)	500,000	500,000
Total convertible preferred stock	12,986,628	12,986,628
Common stock - $.001 par value; 150,000,000 shares authorized; 24,431,204 shares issued and outstanding at March 30, 2013 and December 29, 2012	24,431	24,431
Additional paid-in capital	53,224,194	53,187,479
Accumulated deficit	(60,802,866)	(58,848,566)
Total stockholders' equity	5,432,387	7,349,972
Total liabilities and stockholders' equity	$24,178,360	$23,322,786

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

iPARTY CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Revenues	$15,795,228	$15,753,745
Operating costs:		
Cost of products sold and occupancy costs	10,296,018	10,026,180
Marketing and sales	5,162,280	5,210,909
General and administrative	2,232,050	1,702,376
Operating loss	(1,895,120)	(1,185,720)
Change in fair value of warrant liability	-	(216)
Interest expense, net	(59,180)	(49,330)
Loss before income taxes	(1,954,300)	(1,235,266)
Income taxes	-	-
Net loss	$(1,954,300)	$(1,235,266)
Loss per share:		
Basic and diluted	$(0.08)	$(0.05)
Weighted-average shares outstanding:		
Basic and diluted	24,431,204	24,408,594

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

iPARTY CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Operating activities:		
Net loss	$(1,954,300)	$(1,235,266)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	227,113	272,065
Amortization	60,542	89,531
Deferred rent	5,717	14,185
Non-cash stock-based compensation expense	36,715	48,702
Change in fair value of warrants	-	216
Changes in operating assets and liabilities:		
Accounts receivable	57,795	670,145
Inventories	(1,090,119)	(647,207)
Prepaid expenses and other assets	27,339	(81,525)
Accounts payable and book overdrafts	471,658	737,465
Accrued expenses and other liabilities	488,479	(162,158)
Net cash used in operating activities	(1,669,061)	(293,847)
Investing activity:		
Purchase of property and equipment	(41,703)	(211,796)
Net cash used in investing activity	(41,703)	(211,796)
Financing activities:		
Net borrowings under line of credit	1,807,304	210,781
Decrease (increase) in restricted cash	(96,940)	295,969
Principal payments on capital lease obligations	-	(2,307)
Net cash provided by financing activities	1,710,364	504,443
Net decrease in cash	(400)	(1,200)
Cash beginning of period	64,650	63,650
Cash end of period	$64,250	$62,450
Supplemental disclosure of non-cash financing activities:		
Disposal of property and equipment	$97,667	$8,258

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

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iPARTY CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 30, 2013
(unaudited)

1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES:

Interim Financial Information

The interim consolidated financial statements as of March 30, 2013 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 29, 2012 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 29, 2012.

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 sales tax, 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. Five suppliers accounted for approximately 50.7% of the Company's purchases of merchandise for 2013, 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, which is a wholly-owned subsidiary of Party City Holdings Inc. 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 for 2009 fell short of the required annual commitment by approximately $368,000. The supplier agreed to allow the Company to roll over any shortfall for the year 2009 into future years' requirements. The Company's purchases in 2010 exceeded the minimum purchase requirements for that year in addition to the 2009 shortfall. The Company's purchases in 2012 and 2011 exceeded the minimum purchase requirements for those years. 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 the original expiration date of December 31, 2012 to December 31, 2013. In addition, on December 30, 2010, the Company agreed with Party City Corporation to take over a location previously operated by Party City Corporation in Manchester, Connecticut on March 1, 2011. As part of the store takeover, the Company entered into an amendment to the Asset Purchase Agreement dated August 7, 2006 with Party City Corporation to extend the term of the non-compete provisions with Party City Corporation and its affiliates contained in the Asset Purchase Agreement from August 7, 2011 until December 31, 2013 and to include a three mile radius around the Manchester, Connecticut location as part of the restricted area in the non-compete provisions.

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 $1,862,327 at March 30, 2013 and $2,000,025 at December 29, 2012.

Restricted cash represents funds on deposit established for the benefit of and under the control of 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 , 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 Facility approximates the carrying value because the debt bears interest at a variable market rate. The fair value at December 25, 2010 of the warrants issued in 2006 was determined by using the Black-Scholes model (implied volatility of 40%, risk free rate of 0.2388% and expected life of 0.7233 years) after considering a probability weighted scenario in which the warrant exercise price adjustment scenario was deemed remote. These warrants expired on September 15, 2011. The fair value at December 29, 2012 of the warrants issued in 2008 was determined by using the Black-Scholes model (implied volatility of 142.39%, risk free rate of 0.01% and expected life of 0.16 years). These warrants expired on February 28, 2013.

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 loss per basic and diluted share available to common stockholders:

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Common shares	$ (1,954,300)	$ (1,235,266)
Convertible preferred Series B-F	-	-
Net loss	$ (1,954,300)	$ (1,235,266)
Net loss per share		
Basic and diluted	$ (0.08)	$ (0.05)
Weighted-average shares outstanding:		
Common shares - basic	24,431,204	24,408,594
Common share equivalents of Series B-F convertible preferred stock	-	-
If - converted weighted-average shares outstanding	24,431,204	24,408,594

The common stock equivalents of Series B-F preferred stock calculated on an as if converted basis totaled 14,499,082 and 14,521,687 shares for the three months ended March 30, 2013 and March 31, 2012, 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 loss per diluted share available to common stockholders were 5,699,172 and 0 in the first quarter of 2013 and 6,135,964 and 100,000 in the first quarter of 2012, 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.

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

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Stock-based compensation expense	$ 36,715	$ 48,702

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 three months ended March 30, 2013 or March 31, 2012.

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 7,608,428 shares remain outstanding at March 30, 2013. 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 MKT.

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.

The weighted average fair value of the options at the date of the grant for options granted during the three months ended March 30, 2013 and March 31, 2012 were estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Risk-free interest rate	N/A	0.82%
Expected volatility	N/A	112.90%
Weighted average expected life (in years)	N/A	6.87
Expected dividends	N/A	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 29, 2012	7,631,745	0.39	0.07 - 1.33	4.7	45,950
Granted	-	-	- - -	-	-
Expired	(23,317)	0.21	0.20 - 0.30	-	5,650
Forfeited	-	-	- - -	-	
Exercised	-	-	- - -	-	
Outstanding - March 30, 2013	7,608,428	0.39	0.07 - 1.33	4.4	1,076,930
Exercisable - March 30, 2013	6,807,552	0.41	0.07 - 1.33	4.2	890,144
Available for grant - March 30, 2013	1,842,821				

The following table summarizes information for options outstanding and exercisable at March 30, 2013:

Price Range	Outstanding Number of Stock Options	Outstanding Weighted Average Remaining Life (Years)	Outstanding Weighted Average Exercise Price	Exercisable Number of Stock Options	Exercisable Weighted Average Exercise Price
$ 0.07 - $ 0.20	2,018,400	7.1	$ 0.12	1,591,018	$ 0.11
0.21 - 0.30	2,154,550	4.7	0.28	1,818,604	0.28
0.31 - 0.50	1,640,570	4.1	0.42	1,603,022	0.42
0.51 - 1.00	1,761,908	1.3	0.81	1,761,908	0.81
1.01 - 1.33	33,000	0.7	1.13	33,000	1.13
Total	7,608,428	4.4	$ 0.39	6,807,552	$ 0.41

The remaining unrecognized stock-based compensation expense related to unvested awards at March 30, 2013 was $123,877 and the period of time over which this expense will be recognized is 1.32 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
Equipment	5 years
Computer hardware and software	3 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.

The first non-compete agreement, from Party City Corporation 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 Corporation to take over a location previously operated by Party City Corporation in Manchester, Connecticut. Under that agreement, the term of the earlier non-compete was extended to December 31, 2013 and the non-compete area was amended to include a three mile radius around the Manchester store. The second non-compete agreement was acquired in connection with the Company's purchase in January 2008 of the two franchised party supply stores in Lincoln and Warwick, Rhode Island. This non-compete, which has expired, covered 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. The second non-compete agreement had 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 108 months). Intangible assets also include legal and other transaction costs incurred related to the purchase of the Peabody, Lincoln and Warwick stores.

Intangible assets as of March 30, 2013 and December 29, 2012 were:

	Mar 30, 2013	Dec 29, 2012
Non-compete agreements	$ 2,358,540	$ 2,358,540
Occupancy valuations	944,716	944,716
Other	157,855	157,855
Intangible assets	3,461,111	3,461,111
Less: accumulated amortization	(3,184,928)	(3,133,782)
Intangible assets, net	$ 276,183	$ 327,329

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Amortization expense for these intangible assets was:

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Amortization expense	$ 51,146	$ 80,135

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. Amortization expense for these intangible assets was $299,571 in 2012 and $307,577 in 2011, respectively. The non-compete agreement amortization expense is included in general and administrative expense on the Consolidated Statements of Operations. The lease valuation amortization expense is included in cost of goods sold and occupancy costs.

Future amortization expense related to these intangible assets as of March 30, 2013 is:

Year	Amount
2013	$ 153,425
2014	55,653
2015	33,556
2016	33,549
Total	$ 276,183

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. In 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. In 2012, the Company determined that another one of its retail stores was impaired due to underperforming sales. As a result of this impairment, a charge of approximately $20,000 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 its remaining stores at March 30, 2013.

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.

On February 28, 2013, the Company and its wholly owned subsidiary entered into the Second Amendment to the Facility. Under the Facility, the Company must maintain a minimum excess availability of 7.5% of the credit limit. The Second Amendment allows the Company to request that the minimum excess availability be reduced to zero for a period of not more than sixty days in the aggregate during the period beginning February 28, 2013 and ending April 30, 2014. The Company may make the request twice during this period.

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 and includes an unused line fee on the unused portion of the revolving credit line. 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, and, under the terms of the Second Amendment to the Facility, for up to a sixty day period for the period February 28, 2013 through April 30, 2014 during which sixty day period the minimum availability is zero. At the current credit limit of $12,500,000, the minimum availability is $937,500. 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 March 30, 2013 and December 29, 2012, 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 March 30, 2013 and December 29, 2012 were $7,571,616 and $5,764,312, respectively. The interest rate on these borrowings was 3.0% at March 30, 2013 and 2.8% at December 29, 2012. 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 March 30, 2013, the Company had $2,678,909 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 Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures. ASC 820 defined fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also described three levels of inputs that may be used to measure the fair value:

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

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

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

The only assets and liabilities subject to fair value measurement standards at March 30, 2013 and December 29, 2012 are cash and restricted cash which are based on Level 1 inputs, and the warrant liability which was based on Level 2 inputs.

Income taxes

The Company has not provided for income taxes for the first quarter of fiscal 2013 or fiscal 2012 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 the Company’s operating loss through March 30, 2013. 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 the Company’s operating results during its fourth quarter.

A valuation allowance is required to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion of the deferred tax assets will not be realized. After consideration of the available evidence, both positive and negative, the Company has determined that a full valuation allowance at March 30, 2013 of $8.9 million is necessary to reduce the net deferred tax assets to the amount that will more likely than not be realized. The Company’s determination of a full valuation allowance at March 30, 2013 was impacted by the Company’s cumulative three year pre-tax loss position as of December 29, 2012.

As of March 30, 2013, the Company has estimated federal net operating loss carryforwards of approximately $16.2 million, which begin to expire in 2020. In accordance with Section 382 of the Internal Revenue Code, the use of some of these carryforwards may be subject to annual limitations based upon ownership changes of the Company’s stock which may have occurred or that may occur.

At March 30, 2013 and December 29, 2012, the Company had no material unrecognized tax benefits and no adjustments to liabilities or operations were required.

New Accounting Pronouncements

In April 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-07, Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting (“ASU 2013-07”). ASU 2013-07 is effective for annual and interim reporting periods for fiscal years beginning after December 15, 2013. Early adoption is permitted. The adoption of this ASU is not expected to have any effect on our consolidated financial statements.

NOTE 2: SUBSEQUENT EVENTS:

On May 9, 2013, pursuant to the terms of the Agreement and Plan of Merger (the “Merger Agreement”), dated as of March 1, 2013, by and among the Company, Party City Holdings Inc., a Delaware corporation (“Party City”), and Confetti Merger Sub, Inc., a Delaware corporation and a wholly-owned subsidiary of Party City (“Merger Sub”), Merger Sub was merged with and into the Company, with the Company being the surviving corporation (the “Merger”). Upon completion of the Merger, the Company became a wholly-owned subsidiary of Party City. In connection with the Merger, the Company (i) paid in full all principal and interest outstanding under the Facility as of the close of the Merger and (ii) is in the process of delisting and deregistering its common stock.

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 29, 2012.

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 29, 2012 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.

Merger Agreement

On May 9, 2013, pursuant to the terms of the Agreement and Plan of Merger (the "Merger Agreement"), dated as of March 1, 2013, by and among the Company, Party City Holdings Inc., a Delaware corporation ("Party City"), and Confetti Merger Sub, Inc., a Delaware corporation and a wholly-owned subsidiary of Party City ("Merger Sub"), Merger Sub was merged with and into the Company, with the Company being the surviving corporation (the "Merger"). Upon completion of the Merger, the Company became a wholly-owned subsidiary of Party City. As a result of the Merger, the Company is in the process of delisting and deregistering its common stock.

Overview

We are a party goods retailer operating stores throughout New England, where 49 of our 54 retail stores are located, and in Florida, in addition to an online e-commerce site. These include our new store opened in the third quarter of 2012, in Plaistow, New Hampshire and our new store in Waltham, Massachusetts, which was opened in early October 2012.

Our 54 retail stores are located predominantly in New England with 7 stores in Connecticut, 7 in New Hampshire, 3 in Rhode Island, 3 in Maine, 1 in Vermont, and 28 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. 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 2012 Halloween season, we operated ten temporary stores. During the 2011 and 2010 Halloween seasons, we operated eleven temporary stores. 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 Party City Corporation 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.

During the first quarter of our fiscal 2013, which ended on March 30, 2013, sales in our comparable stores decreased 2.4% compared to sales in the first quarter of 2012. Comparable stores are defined as stores open more than one year.

Our stores range in size from approximately 7,000 square feet to approximately 20,521 square feet and average approximately 10,300 square feet in size.

We lease our properties, typically for 10 years and usually with options from our landlords to renew our leases for an additional 5 or 10 years.

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

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Beginning of period	54	52
Openings / Acquisitions	-	1
Closings	-	(1)
End of period	54	52

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 35.7% of our annual revenues in our fourth quarter, which includes Halloween and Christmas, and an average of approximately

24.6% of our annual 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.

First Quarter Summary

For the first quarter of 2013, our consolidated revenues were $15.80 million, compared to $15.75 million for the first quarter of 2012. The increase in consolidated revenue was driven primarily by the sales in our new stores in Plaistow, New Hampshire and Waltham, Massachusetts, partly offset by the decrease in sales in our comparable stores of 2.4%. In the first quarter of 2013, consolidated gross profit margin was 34.8% for the first quarter of 2013, compared to a gross profit margin of 36.4% for the same period in 2012. The gross profit margin components included a decrease of 1.0% in product selling margin rate, primarily the result of the timing of clearance markdowns. The consolidated net loss for the first quarter of 2013 was $2.0 million, or $0.08 per share, compared to $1.2 million, or $0.05 per share, for the first quarter of 2012.

Results of Operations

Fiscal year 2013 has 52 weeks and ends on December 28, 2013. Fiscal year 2012 had 52 weeks and ended on December 29, 2012.

The first quarter of fiscal year 2013 had 13 weeks and ended on March 30, 2013. The first quarter of fiscal year 2012 had 13 weeks and ended on March 31, 2012.

Three Months Ended March 30, 2013 Compared to Three Months Ended March 31, 2012

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 first quarter of fiscal 2013 were $15,795,228, an increase of $41,483, or 0.3% from the first quarter of the prior fiscal year, and included a decrease in comp store sales of 2.4% for the quarter. The increase in total sales was primarily due to the sales in new stores, partly offset by the decrease in comparable store sales.

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Revenues	$ 15,795,228	$ 15,753,745
Increase (decrease) in revenues	0.3 %	4.4 %

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 quarter of fiscal 2013 were $10,296,018 or 65.2% of revenues, an increase of $269,838 and an increase of 1.6% as a percentage of revenues, compared to the first quarter of the prior fiscal year.

	For the three months ended	
	Mar 30, 2013	Mar 31, 2012
Cost of products sold and occupancy costs	$ 10,296,018	$ 10,026,180
Percentage of revenues	65.2 %	63.6 %

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As a percentage of revenues, cost of products sold and occupancy costs included a decrease in product selling margins of 1.0%. The decrease in selling margin was primarily caused by the timing of clearance markdowns.

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 quarter of fiscal 2013 was $5,162,280, or 32.7% of revenues, a decrease of $48,629, or 0.4 percentage points, as a percentage of revenues, from the first quarter of the prior fiscal year.

	For the three months ended					
	Mar 30, 2013			Mar 31, 2012		
Marketing and sales	$	5,162,280		$	5,210,909	
Percentage of revenues		32.7	%		33.1	%

The decrease in marketing and sales expense as a percentage of sales was primarily due to decreases in advertising costs and store depreciation.

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 quarter of fiscal 2013 was $2,232,050 or 14.1% of revenues, an increase of $529,674 or 3.3 percentage points, as a percentage of revenues, from the first quarter of the prior fiscal year.

	For the three months ended					
	Mar 30, 2013			Mar 31, 2012		
General and administrative	$	2,232,050		$	1,702,376	
Percentage of revenues		14.1	%		10.8	%

The increase in general and administrative costs was primarily due to increased professional fees related to the Merger.

Operating loss

Our operating loss for the first quarter of fiscal 2013 was $1,895,120, or 12.0% of revenues, as compared to $1,185,720, or 7.5% of revenues for the first quarter of the prior fiscal year. The increase in operating loss was primarily due to an increase in professional fees.

Interest expense

Our interest expense in the first quarter of fiscal 2013 was $59,180, an increase of $9,850 from the first quarter of the prior fiscal year. The increase in the first quarter of fiscal 2013 as compared to the prior period was primarily due to a higher average loan balance in the first quarter of 2013 compared to the same period in 2012.

Income taxes

We have not provided for income taxes for the first quarter of fiscal 2013 or fiscal 2012 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 March 30, 2013. 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 2013.

At the end of 2012, we had estimated federal net operating loss carryforwards of approximately $16.2 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 loss in the first quarter of fiscal 2013 was $1,954,300, or $0.08 per basic and diluted share compared to $1,235,266, or $0.05 basic and diluted share in the first quarter of the prior fiscal year.

Liquidity and Capital Resources

Our primary uses of cash are (i) purchases of inventory, including purchases under our Supply Agreement with Amscan, as described more fully below; (ii) occupancy expenses of our stores; (iii) employee salaries; and (iv) new and temporary store openings, including acquisitions.

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 we will have sufficient liquidity to fund our operations, working capital requirements and capital expenditures through the next twelve months. Primary sources of liquidity will be from our cash from operating activities and, prior to the Merger, our credit facility with Wells Fargo, and, following the Merger, access to liquidity from Party City, our parent corporation, which will provide us with long-term liquidity.

Prior to the Merger, we were a party to that certain First Amendment (“Amendment”) to the Second Amended and Restated Credit Agreement (the “Facility”) with Wells Fargo, which was further amended on February 28, 2013. The Facility provided credit in the amount of up to $12,500,000 for five years through October 14, 2016. The amount of credit that was available from time to time under the Facility was 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. In connection with the Merger, the Company paid in full all principal and interest outstanding under the Facility as of the close of the Merger, and Wells Fargo no longer has any obligations to provide borrowings under the Facility.

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

The Facility had financial covenants that were limited to minimum availability and capital expenditures and contained various restrictive covenants, such as incurrence, payment or entry into certain indebtedness, liens, investments, acquisitions, mergers, dispositions and dividends.

The Facility also required 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 March 30, 2013, 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. 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. The Company is not aware of any reason that would prevent it from meeting the minimum purchase requirements for 2013.

Operating, Investing and Financing Activities

Our operating activities used cash of $1,669,061 during the three months ended March 30, 2013 compared to using $293,847 during the three months ended March 31, 2012, an increase in cash used of $1,375,214. The increase in cash used in operating activities was primarily due to an increase in inventory purchases and an increase in net loss for the three months ended March 30, 2013 compared to the same period in 2012, plus a reduction in the decrease in credit card accounts receivable for the first quarter of 2013 compared to the first quarter of 2012.

We used $41,703 in investing activity during the first three months of 2013 compared to $211,796 during the first three months of 2012, a decrease of $170,093. The cash invested in 2013 was primarily for improvements to our existing retail stores. The cash invested in 2012 was primarily for improvements to our existing retail stores, leasehold improvements and fixtures for our two new permanent stores in Plaistow, New Hampshire and Waltham, MA, and point of sale register updates.

Financing activities provided $1,710,364 during the first three months of 2013 compared to providing $504,443 during the first three months of 2012, an increase of $1,205,921. The increase was due to increased net borrowings on the line of credit during the first three months of 2013 compared to the first three months of 2012.

Contractual Obligations

Contractual obligations at March 30, 2013 were as follows:

	Within 1 Year	Within 2 - 3 Years	Within 4 - 5 Years	After 5 Years	Total
Line of credit	$7,584,458	$-	$-	$-	$7,584,458
Supply agreement	6,954,139	-	-	-	6,954,139
Operating leases (including retail space leases)	10,169,850	16,328,920	11,466,385	7,690,774	45,655,929
Total contractual obligations	$24,708,447	$16,328,920	$11,466,385	$7,690,774	$60,194,526

In addition, at March 30, 2013, we had outstanding purchase orders totaling approximately $3,660,605 for the acquisition of inventory and non-inventory items that were scheduled for delivery after March 30, 2013.

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 March 30, 2013, we operated a total of 54 stores, 49 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 helium filled balloons. These and other issues directly or indirectly affecting our vendors, our customers and us could adversely affect our business and financial performance.

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 29, 2012, as amended on April 26, 2013, 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 29, 2012 included in Item 8 of our Annual Report on Form 10-K for that fiscal year, as filed with the SEC on March 29, 2013, and as amended on April 26, 2013). 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 2012 included an estimated reduction of $42,111 to the cost of products sold during the previous three quarters.

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Revenue Recognition

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

Property and Equipment

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

Intangible Assets

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

The first non-compete agreement, from Party City and its affiliates, covered 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 and the geographical scope of this non-compete agreement was expanded to include a part of Hartford County in Connecticut in conjunction with the Company’s agreement with Party City Corporation to take over a store previously operated by Party City Corporation in Manchester, Connecticut. This non-compete agreement is subject to certain terms and conditions as set forth in the acquisition agreement for the purchase of the retail stores in 2006.

The second non-compete agreement was acquired in connection with our purchase in January 2008 of two franchised party supply stores in Lincoln and Warwick, Rhode Island. The acquired Rhode Island stores had been operated as Party City franchise stores, and were converted to iParty stores immediately following the closing. The second non-compete agreement, which has expired, covered Rhode Island for five years from the date of closing and within a certain distance from our stores in the rest of New England for three years. The second non-compete agreement had an estimated life of 60 months.

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 108 months). Intangible assets also include legal and other transaction costs incurred related to the purchase of the Peabody, Lincoln and Warwick stores.

Non-compete agreements are amortized based on the pattern of their expected cash flow benefits. Occupancy valuations are amortized 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 2012, 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 $20,000 for the period ended December 29, 2012 to reduce to fair value the carrying value of the property and equipment utilized in this store. In addition, 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 for the period ended December 31, 2011 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 stores at March 30, 2013.

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 seven out of the last ten 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, 2011 and 2012, (2) our merchandise margins decreased in 2005 and 2006, and in each of the years 2008 through 2012, (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 federal net operating loss carryforwards of approximately $16.2 million at December 29, 2012, (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 costs that 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.

Based on the balance of positive and negative evidence, we determined that a full valuation allowance is necessary to reduce the net deferred tax assets to the amount that will more likely than not be realized. 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. 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 April 2013, FASB issued Accounting Standards Update ("ASU") 2013-07, Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting ("ASU 2013-07"). ASU 2013-07 is effective for annual and interim reporting periods for fiscal years beginning after December 15, 2013. Early adoption is permitted. The adoption of this ASU 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 29, 2012, which was filed with the SEC on March 29, 2013, and amended on April 26, 2013.

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 March 30, 2013, 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 March 30, 2013 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

On March 8, 2013, a putative shareholder class action lawsuit was filed against the Company, members of the Company's Board of Directors, Party City and Merger Sub in the Massachusetts Superior Court (Suffolk County) (Vincent Sean Halstead, individually and on behalf of all other similarly situated vs. iParty Corp. et al, B.L.S. 13-0842) (the "Halstead Complaint"), which complaint was amended on April 10, 2013. The action alleges that the members of the Company's Board of Directors violated their fiduciary duties by failing to maximize shareholder value when negotiating and entering into the Merger Agreement and filing a materially false and misleading proxy statement. The complaint alleges that Party City and Merger Sub aided and abetted those purported violations of fiduciary duties.

On May 1, 2013, the Company, Party City, Merger Sub, and plaintiff in the Halstead Complaint reached an agreement-in-principle providing for the settlement of the outstanding litigation on the terms and conditions set forth in a memorandum of understanding (the "MOU"). Pursuant to the terms of the MOU, without agreeing that any of the claims in the Halstead Complaint have merit or that any supplemental disclosure was required under any applicable statute, rule, regulation or law, the Company agreed to make certain supplemental and amended disclosures in connection with its definitive proxy statement filed with the Commission on April 10, 2013. The MOU further provides that, among other things, (a) the parties to the MOU will enter into a definitive settlement agreement (the "Agreement") and will submit the Agreement to the Suffolk County Superior Court (the "Court") for review and approval; (b) the Agreement will provide for dismissal of the Halstead Complaint with prejudice; (c) the Agreement will include a general release of defendants of claims relating to the transaction; and (d) the proposed settlement is conditioned on final approval by the Court. There can be no assurance that the settlement will be finalized or that the Court will approve the settlement.

The Company and the other defendants have vigorously denied, and continue vigorously to deny, that they have committed or aided and abetted in the commission of any violation of law or engaged in any of the wrongful acts that were or could have been alleged in the referenced lawsuits, and expressly maintain that, to the extent applicable, they diligently and scrupulously complied with any applicable fiduciary and other legal duties. The Company and the other defendants entered into the contemplated settlement solely to eliminate the burden and expense of further litigation, to put the claims that were or could have been asserted to rest, and to avoid any adverse effects due to any possible delay to the closing of the Merger that might have arisen from further litigation. Nothing in this Quarterly Report on Form 10-Q, the MOU or any stipulation of settlement shall be deemed an admission of the legal necessity or materiality under applicable laws of any of the amended and supplemental disclosures or any of the allegations in the Halstead Complaint.

In addition, we are periodically involved in additional litigation or claims that arise in the ordinary course of business. Management believes that the ultimate resolution of any such additional litigation or claims currently pending, individually or in the aggregate, is not expected to have a material adverse effect on our company.

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 29, 2012, as filed with the SEC on March 29, 2013, and as amended on April 26, 2013.

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

Dated: May 23, 2013

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION
Ex. 2.1	Agreement and Plan of Merger, dated March 1, 2013 by and among iParty Corp., Party City Holdings Inc. and Confetti Merger Sub, Inc. (Incorporated by reference from the Company's Current Report on Form 8-K dated February 28, 2013, as filed with the Commission on March 1, 2013)*
Ex. 2.2	Form of Voting Agreement dated March 1, 2013 between Party City Holdings Inc. and certain stockholders (Incorporated by reference from the Company's Current Report on Form 8-K dated February 28 2013, as filed with the Commission on March 1, 2013)
Ex. 4.1	Amendment No. 1 dated March 1, 2013 to the Rights Agreement dated October 7, 2011 by and between iParty Corp. and Continental Stock Transfer & Trust Company (Incorporated by reference from the Company's Current Report on Form 8-K dated February 28, 2013, as filed with the Commission on March 1, 2013)
Ex. 10.1	Second Amendment dated February 28, 2013 to Second Amended and Restated Credit Agreement among iParty Corp. and iParty Retail Stores Corp., as borrowers, and Wells Fargo Bank, National Association, as Administrative Agent and Collateral Agent (Incorporated by reference from the Company's Current Report on Form 8-K dated February 28, 2013, as filed with the Commission on March 1, 2013)
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**

* The Company has omitted certain schedules in accordance with Regulation S-K 601(b)(2). The Company will furnish the omitted schedules to the Commission upon request.

**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.