

IPARTY CORP
Form 10-Q
October 31, 2007

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

FORM 10-Q

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

For the Quarterly Period Ended September 29, 2007

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 0-25507

iPARTY CORP.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of
Incorporation or Organization)

76-0547750

(I.R.S. Employer
Identification No.)

**270 Bridge Street, Suite 301,
Dedham, Massachusetts**

(Address of Principal Executive Offices)

02026

(Zip Code)

(781) 329-3952

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one).
Large accelerated filer Accelerated filer Non-accelerated filer

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

No p

As of October 26, 2007 there were 22,693,957 shares of common stock, \$.001 par value, outstanding.

iPARTY CORP.
QUARTERLY REPORT ON FORM 10-Q
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PART I - FINANCIAL INFORMATION**Item 1. Financial Statements****iPARTY CORP.
CONSOLIDATED BALANCE SHEETS**

	Sep 29, 2007	Dec 30, 2006
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 65,587	\$ 760,376
Restricted cash	634,583	706,066
Accounts receivable	1,068,984	1,116,042
Inventory, net	17,361,748	12,264,737
Prepaid expenses and other assets	1,200,219	752,172
Total current assets	20,331,121	15,599,393
Property and equipment, net	4,537,609	4,817,993
Intangible assets, net	1,816,159	2,153,482
Other assets	100,871	126,505
Total assets	\$ 26,785,760	\$ 22,697,373
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 11,002,929	\$ 5,516,406
Accrued expenses	2,824,379	3,070,003
Current portion of capital lease obligations	30,473	343,761
Current notes payable	603,810	551,515
Borrowings under line of credit	2,544,679	1,162,719
Total current liabilities	17,006,270	10,644,404
Long-term liabilities:		
Capital lease obligations, net of current portion	17,524	42,456
Notes payable, net of discount	3,381,994	3,736,309
Other liabilities	1,067,689	929,199
Total long-term liabilities	4,467,207	4,707,964
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock - \$.001 par value; 10,000,000 shares authorized, Series B convertible preferred stock - 1,150,000 shares authorized; 468,401 and 471,401 shares issued and outstanding at Sep 29, 2007 and Dec 30, 2006, respectively (aggregate liquidation value of \$9,368,024 at Sep 29, 2007)	6,969,810	7,014,450
Series C convertible preferred stock - 100,000 shares authorized, issued and outstanding (aggregate liquidation value of \$2,000,000 at Sep 29, 2007)	1,492,000	1,492,000
Series D convertible preferred stock - 250,000 shares authorized, issued and outstanding (aggregate liquidation value of \$5,000,000 at Sep 29, 2007)	3,652,500	3,652,500
Series E convertible preferred stock - 296,667 shares authorized, issued and outstanding (aggregate liquidation value of \$1,112,500 at Sep 29, 2007)	1,112,500	1,112,500
Series F convertible preferred stock - 114,286 shares authorized, issued and outstanding (aggregate liquidation value of \$500,000 at Sep 29, 2007)	500,000	500,000

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Total convertible preferred stock	13,726,810	13,771,450
Common stock - \$.001 par value; 150,000,000 shares authorized; 22,660,467 and 22,603,877 shares issued and outstanding at Sep 29, 2007 and Dec 30, 2006, respectively	22,660	22,604
Additional paid-in capital	51,807,322	51,671,084
Accumulated deficit	(60,244,509)	(58,120,133)
Total stockholders' equity	5,312,283	7,345,005
Total liabilities and stockholders' equity	\$ 26,785,760	\$ 22,697,373

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

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iPARTY CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	For the three months ended		For the nine months ended	
	Sep 29, 2007	Sep 30, 2006	Sep 29, 2007	Sep 30, 2006
Revenues	\$ 18,208,760	\$ 17,240,535	\$ 54,219,838	\$ 49,373,503
Operating costs:				
Cost of products sold and occupancy costs	10,679,713	10,266,805	31,687,361	29,662,875
Marketing and sales	6,620,424	6,583,780	18,286,196	17,931,894
General and administrative	1,828,865	1,639,993	5,700,919	4,737,681
Operating loss	(920,242)	(1,250,043)	(1,454,638)	(2,958,947)
Interest income	1,198	-	4,679	592
Interest expense	(214,614)	(222,285)	(674,417)	(550,398)
Loss before income taxes	(1,133,658)	(1,472,328)	(2,124,376)	(3,508,753)
Income taxes	-	-	-	-
Net loss	\$ (1,133,658)	\$ (1,472,328)	\$ (2,124,376)	\$ (3,508,753)
Loss per share:				
Basic and diluted	\$ (0.05)	\$ (0.07)	\$ (0.09)	\$ (0.16)
Weighted-average shares outstanding:				
Basic and diluted	22,642,280	22,555,333	22,626,550	22,549,026

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

iPARTY CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	For the nine months ended	
	Sep 29, 2007	Sep 30, 2006
Operating activities:		
Net loss	\$ (2,124,376)	\$ (3,508,753)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,264,302	938,038
Deferred rent	138,490	167,055
Non cash stock based compensation expense	87,071	26,439
Non cash warrant expense	153,413	17,046
Changes in operating assets and liabilities:		
Accounts receivable	47,058	274,959
Inventory	(5,097,011)	(3,226,634)
Prepaid expenses and other assets	(469,127)	(1,188,807)
Accounts payable	5,486,523	6,927,123
Accrued expenses and other liabilities	(246,920)	(146,486)
Net cash (used in) provided by operating activities	(760,577)	279,980
Investing activities:		
Acquisition of retail store and non-compete agreement	-	(1,869,115)
Purchase of property and equipment	(650,536)	(432,045)
Net cash used in investing activities	(650,536)	(2,301,160)
Financing activities:		
Net borrowings under line of credit	1,381,960	(1,329,516)
Proceeds from (principal payments on) notes payable	(455,433)	4,319,373
Decrease (increase) in restricted cash	71,483	(145,811)
Principal payments on capital lease obligations	(338,220)	(354,175)
(Payment) amortization of deferred financing costs	51,951	(126,561)
Proceeds from exercise of stock options	4,583	3,890
Net cash provided by financing activities	716,324	2,367,200
Net increase (decrease) in cash and cash equivalents	(694,789)	346,020
Cash and cash equivalents, beginning of period	760,376	699,194
Cash and cash equivalents, end of period	\$ 65,587	\$ 1,045,214
Supplemental disclosure of non-cash financing activities:		
Conversion of Series B convertible preferred stock to common stock	\$ 44,640	\$ 7,451

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

iPARTY CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 29, 2007
(Unaudited)

1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES:

Interim Financial Information

The interim consolidated financial statements as of September 29, 2007 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the consolidated balance sheets, consolidated operating results, and consolidated cash flows for the periods presented in accordance with generally accepted accounting principles. The consolidated balance sheet at December 30, 2006 has been derived from the audited consolidated financial statements at that date. Operating results for the Company on a quarterly basis may not be indicative of the results for the entire year due, in part, to the seasonality of the party goods industry. Historically, higher revenues and operating income have been experienced in the second and fourth fiscal quarters, while the Company has generated losses in the first and third quarters. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, and accompanying notes, included in the Company's Annual Report on Form 10-K, for the year ended December 30, 2006.

Principles of Consolidation

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

Revenue Recognition

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

Concentrations

The Company purchases its inventory from a diverse group of vendors. Four suppliers account for approximately 37% of the Company's purchases of merchandise, but the Company does not believe that it is overly dependent upon any single source for its merchandise, often using more than one vendor for similar kinds of products. The Company entered into a Supply Agreement with its largest supplier on August 7, 2006, which obligates the Company to purchase increased levels of merchandise until 2012. The Supply Agreement provides for a ramp-up period during 2006 and 2007 and, for five years beginning with calendar year 2008, requires the Company to purchase on an annual basis merchandise equal to the total number of stores open during such calendar year, multiplied by \$180,000. The Supply Agreement provides for penalties in the event the Company fails to attain the annual purchase commitment that would require the Company to pay the difference between the purchases for that year and the annual purchase commitment for that year. The Company is not aware of any reason or circumstance that would prevent the minimum purchase amount commitments under the Supply Agreement from being met.

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

Company does not require collateral.

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Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents and Restricted Cash

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

The Company uses controlled disbursement banking arrangements as part of its cash management program. Outstanding checks, which were included in accounts payable, totaled \$1,119,159 at September 29, 2007 and \$2,316,026 at December 30, 2006. The decrease in outstanding checks as of September 29, 2007 is due to the timing of store lease payments.

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

Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term nature of these instruments. The fair value of borrowings under the Company's line of credit approximates carrying value because the debt bears interest at a variable market rate. The fair value of the capital lease obligations approximates the carrying value. The fair value of the notes payable approximates the carrying value. The fair value of the warrants was determined by using the Black-Scholes model (volatility of 108%, interest of 4.73% and expected life of five years).

Inventories

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

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

	Nine months ended	Twelve months ended
	Sep 29, 2007	Dec 30, 2006
Beginning balance	\$ 1,079,814	\$ 1,098,972
Increases to reserve	265,000	524,550
Write-offs against reserve	(331,884)	(543,708)
Ending balance	\$ 1,012,930	\$ 1,079,814

Income Taxes

The Company adopted the provisions of Financial Accounting Standards Board (“FASB”) Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109” (“FIN 48”) on December 31, 2006. At the adoption date and as of September 29, 2007, the Company had no material unrecognized tax benefits and no adjustments to liabilities, retained earnings or operations were required.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense which were zero for the nine months ended September 29, 2007.

Tax years 2004 through 2006 are subject to examination by the federal and state taxing authorities. There are no income tax examinations currently in process.

Net Loss per Share

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

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

As of September 29, 2007, there were 28,302,342 potential additional common share equivalents outstanding, which were not included in the calculation of diluted net loss per share for the nine months then ended because their effect would be anti-dilutive. These included 15,550,121 shares upon the conversion of immediately convertible preferred stock, 2,083,334 shares upon the exercise of a warrant with an exercise price of \$0.475 per share, 528,210 shares upon the exercise of warrants with a weighted average exercise price of \$3.79 per share and 10,140,677 shares upon the exercise of stock options with a weighted average exercise price of \$0.59 per share.

Stock Option Compensation Expense

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

Under Statement No. 123(R), the Company uses the Black-Scholes option pricing model to determine the fair value of stock based compensation. The Black-Scholes model requires the Company to make several subjective assumptions, including the estimated length of time employees will retain their vested stock options before exercising them (“expected term”), and the estimated volatility of the Company’s common stock price over the expected term, which is based on historical volatility of the Company’s common stock over a time period equal to the expected term. The

Black-Scholes model also requires a risk-free interest rate, which is based on the U.S. Treasury yield curve in effect at the time of the grant, and the dividend yield on the Company's common stock, which is assumed to be zero since the Company does not pay dividends and has no current plans to do so in the future. Changes in these assumptions can materially affect the estimate of fair value of stock based compensation and consequently, the related expense recognized on the consolidated statement of operations. Under the modified prospective method, stock based compensation expense is recognized for new grants beginning in the fiscal year ended December 30, 2006 and any unvested grants prior to the adoption of Statement No. 123(R). The Company recognizes stock based compensation expense on a straight-line basis over the vesting period of each grant.

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The stock based compensation expense recognized by the Company was:

	For the three months ended		For the nine months ended	
	Sep 29, 2007	Sep 30, 2006	Sep 29, 2007	Sep 30, 2006
Stock Based Compensation Expense	\$ 56,633	\$ 11,862	\$ 87,071	\$ 26,439

Stock based compensation expense is included in general and administrative expense. The adoption of Statement No. 123(R) had no impact on cash flow from operations and cash flow from financing activities for the nine months ended on September 29, 2007.

As previously disclosed in our Current Reports on Form 8-K filed on January 8 and March 26, 2007, Patrick Farrell, who relocated from the Boston area to the New York City area for personal reasons earlier this year, has been serving as President of iParty Corp. under an employment agreement with the Company which expires on November 15, 2007. At the Board of Directors meeting held on September 26, 2007, the Board determined not to take any action to extend or renew Mr. Farrell's employment agreement upon its expiration. Mr. Farrell holds vested options to purchase an aggregate of 970,087 shares of the Company's common stock. Under the terms of the option plan and agreements, these options expire on February 15, 2008, based upon his termination on November 15, 2007. However, at the September 26 meeting, the Board, with the approval and upon the recommendation of the Compensation Committee, voted to extend the expiration date of Mr. Farrell's options for an additional six months, to August 15, 2008. As a result, additional stock based compensation of \$14,569, representing the change in the fair value of these options immediately before and after this modification, was recorded as of September 26, 2007 as required by Statement No. 123(R).

Under the Company's Amended and Restated 1998 Incentive and Nonqualified Stock Option Plan (the "1998 Plan") options to acquire 11,000,000 shares of common stock may be granted to officers, directors, key employees and consultants. The exercise price for qualified incentive options cannot be less than the fair market value of the stock on the grant date and the exercise price of nonqualified options can be fixed by the Board. Options to purchase the Company's common stock under the 1998 Plan have been granted to employees, directors and consultants of the Company at fair market value at the date of grant. Generally, the options become exercisable over periods of up to four years, and expire ten years from the date of grant.

The Company granted options for the purchase of 1,350,000 shares of common stock to key employees and each of the four independent members of the Board of Directors on June 6, 2007 at an exercise price of \$0.42 per share. Similarly, the Company granted options for the purchase of 25,000 shares of common stock to each of the four independent members of the Board of Directors on June 7, 2006 at an exercise price of \$0.36 per share. The weighted-average fair market value using the Black-Scholes option-pricing model of the options granted was \$0.33 per share for options granted during the nine months ended September 29, 2007, and was \$0.30 per share for options granted during the nine months ended September 30, 2006. The fair market value of the stock options at the date of the grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the three months ended		For the nine months ended	
	Sep 29, 2007	Sep 30, 2006	Sep 29, 2007	Sep 30, 2006
Risk-free interest rate	N/A	N/A	4.94%	5.18%
Expected volatility	N/A	N/A	102.6%	115.6%
Weighted average expected life (in years)	N/A	N/A	5.0	5.0
Expected dividends	N/A	N/A	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 30, 2006	8,922,440	\$ 0.62	\$0.13 - \$ 4.25		
Granted	1,350,000	0.42	0.42 - 0.42		
Expired/Forfeited	(115,361)	0.55	0.20 - 0.69		
Exercised	(16,402)	0.28	0.23 - 0.36		
Outstanding - September 29, 2007	10,140,677	\$ 0.59	\$0.13 - \$ 4.25	5.0	\$ 663,626
Exercisable - September 29, 2007	8,779,365	\$ 0.62	\$0.13 - \$ 4.25	4.3	\$ 663,626
Available for grant - September 29, 2007	424,062				

The following table summarizes information for options outstanding and exercisable at September 29, 2007:

Price Range	Number of Stock Options	Outstanding	Weighted Average Exercise Price	Exercisable	Weighted Average Exercise Price
		Weighted Average Remaining Life (Years)		Number of Stock Options	
\$ 0.13 - \$ 0.20	139,250	3.9	\$ 0.18	139,250	\$ 0.18
0.21 - 0.30	3,792,682	3.5	0.25	3,792,682	0.25
0.31 - 0.50	2,474,527	7.5	0.39	1,123,726	0.35
0.51 - 1.00	3,093,018	5.5	0.77	3,082,507	0.78
1.01 - 3.50	541,200	1.8	2.33	541,200	2.33
3.51 - 4.25	100,000	2.2	4.14	100,000	4.14
Total	10,140,677	5.0	\$ 0.59	8,779,365	\$ 0.62

The total fair value of shares vested and recognized as expense during the nine months ended September 29, 2007 was \$3,491. The remaining unrecognized stock based compensation expense related to unvested awards at September 29, 2007, was \$403,255 and the period of time over which this expense will be recognized is 4.25 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 the value of a five-year non-compete agreement from Party City Corporation and its affiliates that covers Massachusetts, Maine, New Hampshire, Vermont, Rhode Island, and Windsor and New London counties in Connecticut which expires in 2011. This asset has an estimated life of 60 months. Also included is the value related to the retail store lease that the Company acquired from Party City in Peabody, Massachusetts. This asset has an estimated life of 90 months. The other intangible assets consist of legal and other transaction fees related to the three-year note payable due on September 15, 2009. These assets are being amortized over the life of the note payable.

Intangible assets as of September 29, 2007 and December 30, 2006 were:

	Sep 29, 2007	Dec 30, 2006
Non-compete agreement	\$ 1,688,609	1,725,069
Occupancy valuation	449,716	460,000
Other	197,752	154,949
Intangible assets	2,336,077	2,340,018
Less: accumulated amortization	(519,918)	(186,536)
Intangible assets, net	\$ 1,816,159	\$ 2,153,482

Amortization expense for these intangible assets was:

	For the three months ended		For the nine months ended	
	Sep 29, 2007	Sep 30, 2006	Sep 29, 2007	Sep 30, 2006
Amortization expense	\$ 104,392	\$ 72,032	\$ 333,382	\$ 72,032

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

Future amortization expense related to these intangible assets as of September 29, 2007 is:

Year	Amount
2007	\$ 112,333
2008	457,894
2009	440,678
2010	406,245
2011	265,527
Thereafter	133,482
Total	\$ 1,816,159

Accounting for the Impairment of Long-Lived Assets

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews each store for impairment indicators whenever events and changes in circumstances suggest that the carrying amounts may not be recoverable from estimated future store cash flows. The Company's review considers store operating results, future sales growth and cash flows. During the fourth quarter of 2006, the Company decided to close

its store in East Providence, Rhode Island effective November 4, 2006 due to underperforming sales. As a result of this closing, the Company incurred a charge in the fourth quarter of 2006 of approximately \$120,000 related to remaining lease payments and other closing costs. In addition, during the third quarter of 2007, the Company decided to close its stores in North Providence, Rhode Island and Auburn, Massachusetts at the end of their lease terms which expire on January 31, 2008. No material impairment costs were incurred as a result of that decision.

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Notes Payable

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

The “Highbridge Note” is a subordinated note in the stated principal amount of \$2,500,000 that bears interest at the rate of prime plus one percent. The note matures on September 15, 2009. Interest only is payable quarterly in arrears and the entire principal balance is due at the maturity date. The original discount associated with warrants issued in conjunction with the Highbridge Note (original discount amount \$613,651) is being amortized using the effective interest method over the life of the note payable. The note payable balance of \$2,107,945 as of September 29, 2007 is presented net of the remaining unamortized discount.

The “Amscan Note” is a subordinated promissory note in the original principal amount of \$1,819,373, with a balance as of September 29, 2007 of \$1,277,859. The note bears interest at the rate of 11.0% per annum and is payable in thirty-six (36) equal monthly installments of principal and interest of \$59,562 beginning on November 1, 2006, and on the first day of each month thereafter until October 1, 2009, when the entire remaining principal balance and all accrued interest are due and payable.

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

Stockholders’ Equity

During the nine months ended September 29, 2007, 16,402 shares of common stock were issued upon the exercise of stock options and 40,188 shares of common stock were issued upon conversion of Series B convertible preferred stock.

Reclassifications

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

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

The following discussion should be read in conjunction with the unaudited Consolidated Financial Statements and related Notes included in Item 1 of this Quarterly Report on Form 10-Q and the audited Consolidated Financial Statements and related Notes and Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, contained in our Annual Report on Form 10-K for the fiscal year ended December 30, 2006.

Certain statements in this Quarterly Report on Form 10-Q, particularly statements contained in this Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words “anticipate”, “believe”, “estimate”, “expect”, “plan”, “intend” and other similar expressions are intended to identify these forward-looking statements, but are not the exclusive means of identifying them. Forward-looking statements included in this Quarterly Report on Form 10-Q or hereafter included in other publicly available documents filed with the Securities and Exchange Commission (“SEC”), reports to our stockholders and other publicly available statements issued or released by us involve known and unknown risks, uncertainties, and other factors which could cause our actual results, performance (financial or operating) or achievements to differ from the future results, performance (financial or operating) or achievements expressed or implied by such forward looking statements. Such future results are based upon our best estimates based upon current conditions and the most recent results of operations. Various risks, uncertainties and contingencies could cause our actual results, performance or achievements to differ materially from those expressed in, or implied by, the forward-looking statements contained in this Quarterly Report on Form 10-Q. These include, but are not limited to, those described below under the heading “Factors That May Affect Future Results” and in Part II, Item 1A, “Risk Factors” as well as under Item 1A, “Risk Factors” of our most recently filed Annual Report on Form 10-K for the year ended December 30, 2006.

Overview

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

Our 50 retail stores are located predominantly in New England with 26 stores in Massachusetts, 7 in Connecticut, 6 in New Hampshire, 2 in Rhode Island, 3 in Maine and 1 in Vermont. We also operate 5 stores in Florida. Our stores range in size from approximately 8,000 square feet to 20,300 square feet and average approximately 9,800 square feet in size. We lease our properties, typically for 10 years and usually with options from our landlords to renew our leases for an additional 5 or 10 years.

The following table shows the number of stores in operation:

	For the nine months ended	
	Sep 29, 2007	Sep 30, 2006
Beginning of period	50	50
Openings / Acquisitions	-	1
Closings	-	-
End of period	50	51

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

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Our business has a seasonal pattern. In the past three years, we have realized approximately 37.5% of our annual revenues in our fourth quarter, which includes Halloween and Christmas, and approximately 23.4% of our revenues in the second quarter, which includes school graduations. Also, during the past three years, we have had net income in our second and fourth quarters and generated losses in our first and third quarters.

For the remainder of 2007, our plan continues to be to increase our comparable store sales growth, increase our gross profit margin percentage and leverage our occupancy costs, marketing and sales expense and general and administrative expense. From time to time, we have been and expect to continue to be presented with opportunities to open new party supplies stores or acquire existing ones. We intend to continue to evaluate such opportunities on a case-by-case basis as they may arise to ascertain if they would be a good strategic fit for our business and would help us increase shareholder value.

On August 15, 2007, we entered into an Asset Purchase Agreement to purchase two franchised Party City Corporation retail stores in Lincoln, Rhode Island and Warwick, Rhode Island, in exchange for aggregate consideration of \$1,350,000, plus up to \$400,000 for associated inventory. Both locations will be converted into iParty stores immediately following the closing. The Asset Purchase Agreement contemplates a closing on or about January 3, 2008.

The Asset Purchase Agreement also provides that the selling Party City franchisees and their affiliates will not compete with us in Rhode Island for a period of five years from closing, and will not compete with us within a three-and-one-half (3-1/2) mile radius anywhere in Massachusetts, Rhode Island, New Hampshire, Vermont, Maine, or Connecticut for a three-year period from closing, subject to certain terms specified in the Asset Purchase Agreement.

Results of Operations

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

The third quarter of fiscal year 2007 had 13 weeks and ended on September 29, 2007. The third quarter of fiscal year 2006 had 13 weeks and ended on September 30, 2006.

Three Months Ended September 29, 2007 Compared to Three Months Ended September 30, 2006

Revenues

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale. Our consolidated revenues for the third quarter of fiscal 2007 were \$18,208,760, an increase of \$968,225, or 5.6% from the third quarter of the prior fiscal year.

	For the three months ended	
	Sep 29, 2007	Sep 30, 2006
Revenues	\$ 18,208,760	\$ 17,240,535
Increase in revenues	5.6%	16.2%

Sales for the third quarter of fiscal 2007 included sales from 49 comparable stores (defined as stores open for at least one full year) and one store that was acquired in August 2006. Comparable store sales for the quarter increased by 4.5%.

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 third quarter of fiscal 2007 were \$10,679,713, or 58.7% of revenues, an increase of \$412,908 and a decrease of 0.9 percentage points, as a percentage of revenues, from the third quarter of the prior fiscal year.

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	For the three months ended	
	Sep 29, 2007	Sep 30, 2006
Cost of products sold and occupancy costs	\$ 10,679,713	\$ 10,266,805
Percentage of revenues	58.7%	59.6%

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

Marketing and sales expense

Marketing and sales expense consists primarily of advertising and promotional expenditures, all store payroll and related expenses for personnel engaged in marketing and selling activities and other non-payroll expenses associated with operating our stores. Our consolidated marketing and sales expense for the third quarter of fiscal 2007 was \$6,620,424, or 36.4% of revenues, an increase of \$36,644 and a decrease of 1.8 percentage points, as a percentage of revenues, from the third quarter of the prior fiscal year.

	For the three months ended	
	Sep 29, 2007	Sep 30, 2006
Marketing and sales	\$ 6,620,424	\$ 6,583,780
Percentage of revenues	36.4%	38.2%

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

General and administrative expense

General and administrative (“G&A”) expense consists of payroll and related expenses for executive, merchandising, finance and administrative personnel, as well as information technology, professional fees and other general corporate expenses. Our consolidated G&A expense for the third quarter of fiscal 2007 was \$1,828,865, or 10.0% of revenues, an increase of \$188,872 and an increase of 0.5 percentage points, as a percentage of revenues, from the third quarter of the prior fiscal year.

	For the three months ended	
	Sep 29, 2007	Sep 30, 2006
General and administrative	\$ 1,828,865	\$ 1,639,993
Percentage of revenues	10.0%	9.5%

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

Operating loss

Our operating loss for the third quarter of fiscal 2007 was \$920,242, or 5.1% of revenues, compared to an operating loss of \$1,250,043, or 7.3% of revenues for the third quarter of the prior fiscal year.

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Interest expense

Our interest expense in the third quarter of fiscal 2007 was \$214,614, a decrease of \$7,671 from the third quarter of the prior fiscal year. The decrease in the third quarter of fiscal 2007 was primarily due to lower borrowings under our line of credit in the third quarter of 2007 versus the third quarter of 2006.

Income taxes

We have not provided for income taxes for the third quarter of fiscal 2007 or fiscal 2006 due to the availability of net operating loss (NOL) carryforwards to eliminate taxable income during those periods. No benefit has been recognized with respect to NOL carryforwards due to the uncertainty of future taxable income.

At the end of fiscal 2006, we had estimated net operating loss carryforwards of approximately \$23.0 million, which begin to expire in 2018. In accordance with Section 382 of the Internal Revenue Code, the use of these carryforwards will be subject to annual limitations based upon certain ownership changes of our stock that have occurred or that may occur.

Net Loss

Our net loss in the third quarter of fiscal 2007 was \$1,133,658, or \$0.05 per basic and diluted share, compared to a net loss of \$1,472,328, or \$0.07 per basic and diluted share, in the third quarter of the prior fiscal year.

Nine Months Ended September 29, 2007 Compared to Nine Months Ended September 30, 2006*Revenues*

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale. Our consolidated revenues for the first nine months of fiscal 2007 were \$54,219,838, an increase of \$4,846,335, or 9.8% from the first nine months of the prior fiscal year.

	For the nine months ended	
	Sep 29, 2007	Sep 30, 2006
Revenues	\$ 54,219,838	\$ 49,373,503
Increase in revenues	9.8%	10.9%

Sales for the first nine months of fiscal 2007 included sales from 49 comparable stores (defined as stores open for at least one full year) and one store that was acquired in August 2006. Comparable store sales for the first nine months increased by 6.9%.

Cost of products sold and occupancy costs

Cost of products sold and occupancy costs consist of the cost of merchandise sold to customers and the occupancy costs for our stores. Our cost of products sold and occupancy costs for the first nine months of fiscal 2007 were \$31,687,361, or 58.4% of revenues, an increase of \$2,024,486 and a decrease of 1.7 percentage points, as a percentage of revenues, from the first nine months of the prior fiscal year.

For the nine months ended

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	Sep 29, 2007	Sep 30, 2006
Cost of products sold and occupancy costs	\$ 31,687,361	\$ 29,662,875
Percentage of revenues	58.4%	60.1%

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

Marketing and sales expense

Marketing and sales expense consists primarily of advertising and promotional expenditures, all store payroll and related expenses for personnel engaged in marketing and selling activities and other non-payroll expenses associated with operating our stores. Our consolidated marketing and sales expense for the first nine months of fiscal 2007 was \$18,286,196, or 33.7% of revenues, an increase of \$354,302 and a decrease of 2.6 percentage points, as a percentage of revenues, from the first nine months of the prior fiscal year.

	For the nine months ended	
	Sep 29, 2007	Sep 30, 2006
Marketing and sales	\$ 18,286,196	\$ 17,931,894
Percentage of revenues	33.7%	36.3%

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

General and administrative expense

General and administrative (“G&A”) expense consists of payroll and related expenses for executive, merchandising, finance and administrative personnel, as well as information technology, professional fees and other general corporate expenses. Our consolidated G&A expense for the first nine months of fiscal 2007 was \$5,700,919, or 10.5% of revenues, an increase of \$963,238 and an increase of 0.9 percentage points, as a percentage of revenues, from the first nine months of the prior fiscal year.

	For the nine months ended	
	Sep 29, 2007	Sep 30, 2006
General and administrative	\$ 5,700,919	\$ 4,737,681
Percentage of revenues	10.5%	9.6%

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

Operating loss

Our operating loss for the first nine months of fiscal 2007 was \$1,454,638, or 2.7% of revenues, compared to an operating loss of \$2,958,947, or 6.0% of revenues for the first nine months of the prior fiscal year.

Interest expense

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Our interest expense for the first nine months of fiscal 2007 was \$674,417, an increase of \$124,019 from the first nine months of the prior fiscal year. The increase in the first nine months of fiscal 2007 was primarily due to the interest, including amortization of discount, related to notes payable that we entered into in fiscal 2006, offset by the interest related to lower borrowings under our line of credit in the third quarter of 2007 versus the third quarter of 2006.

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Income taxes

We have not provided for income taxes for the first nine months of fiscal 2007 or fiscal 2006 due to availability of net operating loss (NOL) carryforwards to eliminate taxable income during those periods. No benefit has been recognized with respect to NOL carryforwards due to the uncertainty of future taxable income.

At the end of fiscal 2006, we had estimated net operating loss carryforwards of approximately \$23.0 million, which begin to expire in 2018. In accordance with Section 382 of the Internal Revenue Code, the use of these carryforwards will be subject to annual limitations based upon certain ownership changes of our stock that have occurred or that may occur.

Net Loss

Our net loss for the first nine months of fiscal 2007 was \$2,124,376, or \$0.09 per basic and diluted share, compared to a net loss of \$3,508,753, or \$0.16 per basic and diluted share, for the first nine months of the prior fiscal year.

Liquidity and Capital Resources

Our operating activities used \$760,577 in the first nine months of fiscal 2007 compared to \$279,980 in cash provided in the first nine months of the prior fiscal year, a decrease of \$1,040,557. The increase in cash used in operating activities was primarily due to higher purchases of inventory and to lower accounts payable growth. The lower accounts payable growth is primarily related to less extended dating from vendors in the first half of 2007 than in 2006.

We used \$650,536 in investing activities in the first nine months of fiscal 2007 compared to \$2,301,160 in the first nine months of the prior fiscal year. The cash invested in the first nine months of fiscal 2007 was primarily due to fixture and equipment improvements in our existing retail stores, plus the implementation of a new human resource information and payroll system. The cash invested in the first nine months of fiscal 2006 was primarily due to the acquisition in August 2006 of a retail store located in Peabody, Massachusetts and a five-year non-compete agreement from Party City.

Our financing activities provided \$716,324 in the first nine months of fiscal 2007 compared to providing \$2,367,200 in the first nine months of the prior fiscal year, a decrease of \$1,650,876. The decrease was primarily related to the borrowings in 2006 to finance the acquisition of the Peabody retail store and the Party City non-compete agreement.

On December 21, 2006, we amended and restated our existing line of credit (the "line") with Wells Fargo Retail Finance II, LLC. The amendment continues the line of credit with Wells Fargo at \$12,500,000 and extends it for three additional years to January 2, 2010. In addition, the new agreement with Wells Fargo includes an option whereby we may increase our line of credit up to a maximum level of \$15,000,000, upon 15 days written notice, as long as we are in compliance with all debt covenants and the other provisions of the loan agreement. Borrowings under the new line bear interest at Wells Fargo's base rate or, at our option, at London Interbank Offered Rate ("LIBOR") plus 1.75%. Beginning March 30, 2007, these rates can increase by no more than 0.25% if average availability under the line falls below \$3,000,000. Borrowings under the line are based on inventory and accounts receivable levels. The line is secured by a lien on substantially all of our assets.

The amended and restated agreement includes a financial covenant requiring us to maintain a minimum availability under the line of 5% of the credit limit. At the current credit limit of \$12,500,000, the minimum availability is \$625,000. The amended agreement also has a covenant that requires us to limit our capital expenditures to within 110% of those amounts included in our business plan, which may be updated from time to time. At September 29, 2007, we were in compliance with these financial covenants. The line generally prohibits the payment of any

dividends or other distributions to any of our classes of capital stock.

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

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The amount outstanding under the line was \$2,544,679 as of September 29, 2007 and \$1,162,719 as of December 30, 2006. The interest rate on these borrowings was 7.8% at September 29, 2007 and 8.6% at December 30, 2006. The outstanding balances under the line are classified as current liabilities in the accompanying consolidated balance sheets since we are required to apply daily lock box receipts to reduce the amount outstanding.

Our inventory consists of party supplies which are valued at the lower of moving weighted-average cost or market and are reduced by an allowance for obsolete and excess inventory and other adjustments, including vendor rebates, discounts and freight costs. Our line of credit availability calculation allows us to borrow against “acceptable inventory at cost,” which is based on our inventory at cost and applies adjustments that our lender has approved which may be different from adjustments we use for valuing our inventory in our financial statements, such as the adjustment to reserve for inventory shortage. The amount of “acceptable inventory at cost” was \$19,037,895 at September 29, 2007.

Our accounts receivable consist primarily of vendor rebate receivables and credit card receivables. Our line of credit availability calculation allows us to borrow against “eligible credit card receivables,” which are the credit card receivables for the previous two to three days of business. The amount of “eligible credit card receivables” was \$317,415 at September 29, 2007.

Our total borrowing base is determined by adding the “acceptable inventory at cost” times an agreed upon advance rate plus the “eligible credit card receivables” times an agreed upon advance rate but not to exceed our established credit limit, which was \$12,500,000 at September 29, 2007. Under the terms of our line of credit, our \$12,500,000 credit limit was further reduced by (1) a minimum availability block, (2) customer deposits, (3) gift certificates, (4) merchandise credits and (5) outstanding letters of credit. Therefore, our availability was \$9,115,830 at September 29, 2007 and \$5,657,200 at December 30, 2006.

On August 7, 2006, we entered into and simultaneously closed an asset purchase agreement with Party City, an affiliate of Amscan Holdings, Inc., pursuant to which we acquired a Party City retail party goods store in Peabody, Massachusetts and received a five-year non-competition covenant from Party City, for aggregate consideration of \$2,450,000, payable by a subordinated note in the principal amount of \$600,000, which bears interest at the rate of 12.25% per annum (the “Party City Note”) and \$1,850,000 in cash. The Party City Note is payable by quarterly interest-only payments over four years, with the full principal amount due at the note’s maturity on August 7, 2010.

On September 15, 2006, we entered into a securities purchase agreement pursuant to which we raised \$2.5 million through a combination of subordinated debt and warrant issued on September 15, 2006 to Highbridge International LLC (“Highbridge”), an institutional accredited investor. Under the terms of the financing, we issued Highbridge a three-year subordinated note (the “Highbridge Note”) that bears interest at an interest rate of prime plus one percent. The note matures on September 15, 2009. In addition, we issued Highbridge a warrant (the “Highbridge Warrant”) exercisable for 2,083,334 shares of our common stock at an exercise price of \$0.475 per share, or 125% of the closing price of our common stock on the day immediately prior to the closing of the transaction. We allocated approximately \$613,651 of value to the warrants using the Black-Scholes model (volatility of 108%, interest of 4.73% and expected life of five years). The note discount associated with the warrants is being amortized using the effective interest method over the life of the note payable.

On October 24, 2006, we converted \$1,143,896 of extended payables originally due to Amscan as of August 8, 2006 as well as an additional \$675,477 of payables due to Amscan as of September 28, 2006 into a single subordinated promissory note in the total principal amount of \$1,819,373 (“the Amscan Note”). The Amscan Note bears interest at the rate of 11.0% per annum and is payable in thirty-six (36) equal monthly installments of principal and interest of \$59,562.48 commencing on November 1, 2006, and on the first day of each month thereafter until October 1, 2009, when the entire remaining principal balance and all accrued interest are due and payable.

On August 15, 2007, we entered into an Asset Purchase Agreement to purchase two franchised Party City Corporation retail stores in Lincoln, Rhode Island and Warwick, Rhode Island, in exchange for aggregate consideration of \$1,350,000, plus up to \$400,000 for associated inventory. Both locations will be converted into iParty stores immediately following the closing. The Asset Purchase Agreement contemplates a closing on or about January 3, 2008.

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

Based on our current operating plan, we believe that anticipated revenues from operations and borrowings available under our line of credit will be sufficient to fund our operations, the planned acquisition of two stores in January 2008 and working capital requirements through at least the next twelve months.

Contractual obligations at September 29, 2007 were as follows:

	Payments Due By Period				Total
	Within 1 Year	Within 2 - 3 Years	Within 4 - 5 Years	After 5 Years	
Line of credit	\$ 2,544,679	\$ -	\$ -	\$ -	\$ 2,544,679
Capital lease obligations	30,473	17,524	-	-	47,997
Notes payable	603,810	3,174,049	600,000	-	4,377,859
Supply agreement		18,000,000	18,000,000	9,000,000	45,000,000
Asset purchase agreement	1,750,000				1,750,000
Operating leases (including retail space leases)	8,516,342	15,801,576	11,748,477	10,305,719	46,372,114
Total contractual obligations	\$ 13,445,304	\$ 36,993,149	\$ 30,348,477	\$ 19,305,719	\$ 100,092,649

In addition, at September 29, 2007, we had outstanding purchase orders totaling approximately \$4,243,478 for the acquisition of inventory and non-inventory items that are scheduled for delivery after September 29, 2007.

Seasonality

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

Geographic Concentration

As of September 29, 2007, we operated a total of 50 stores, 45 of which are located in New England. As a result, a severe or prolonged regional recession or regional changes in demographics, employment levels, population, weather patterns, real estate market conditions, consumer confidence and spending patterns or other factors specific to the New England region may adversely affect us more than a company that is more geographically diverse.

Effects of Inflation

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

Factors That May Affect Future Results

Our business is subject to certain risks that could materially affect our financial condition, results of operations, and the value of our common stock. These risks include, but are not limited to, the ones described under Item 1A, “Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended December 30, 2006 and Part II, Item 1A, “Risk Factors” of subsequent Quarterly Reports on Form 10-Q, including this one. Additional risks and uncertainties that we are unaware of, or that we may currently deem immaterial, may become important factors that harm our business, financial condition, results of operations, or the value of our common stock.

Critical Accounting Policies and Estimates

Our financial statements are based on the application of significant accounting policies, many of which require management to make significant estimates and assumptions (see Note 1 to the Consolidated Financial Statements). We believe the following accounting policies to be those most important to the portrayal of our financial condition and those that require the most subjective judgment. If actual results differ significantly from management’s estimates and projections, there could be a material effect on our financial statements.

Inventory and Related Allowance for Obsolete and Excess Inventory

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

During each interim reporting period, we estimate the impact on cost of products sold associated with inventory shortage. The actual inventory shortage is determined upon reconciliation of the annual physical inventory, which occurs shortly before and after our year end, and an adjustment to cost of products sold is recorded at the end of the fourth quarter to recognize the difference between the estimated and actual inventory shortage for the full year.

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

Revenue Recognition

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

Property and Equipment

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

Impairment of Long-Lived Assets

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we perform a review of each store for impairment indicators whenever events and changes in circumstances suggest that the carrying amounts may not be recoverable from estimated future store cash flows. Our review considers store

operating results, future sales growth and cash flows. The conclusion regarding impairment may differ from current estimates if underlying assumptions or business strategies change. During the fourth quarter of 2006, we decided to close our store in East Providence, Rhode Island effective November 4, 2006 due to underperforming sales. As a result of this closing, we incurred a charge in the fourth quarter of 2006 of approximately \$120,000 related to remaining lease payments and other closing costs. In addition, during the third quarter of 2007, we decided to close our stores in North Providence, Rhode Island and Auburn, Massachusetts at the end of their lease terms which expire on January 31, 2008. No material impairment costs were incurred as a result of that decision.

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Income Taxes

Historically, we have not recognized an income tax benefit for our losses. Accordingly, we record a valuation allowance against our deferred tax assets because of the uncertainty of future taxable income and the realizability of the deferred tax assets. In determining if a valuation allowance against our deferred tax asset is appropriate, we consider both positive and negative evidence. The positive evidence that we considered included (1) we were profitable in 2006, 2004 and 2003 due to the success of our Halloween seasons, (2) we have achieved positive comparable store sales growth for the last three full years and (3) improved merchandise margins in 2006, 2004 and 2003. The negative evidence that we considered included (1) after two years of profitability we realized a net loss in 2005, (2) our merchandise margins decreased in 2005, (3) our future profitability is vulnerable to certain risks, including (a) the risk that we may not be able to generate significant taxable income to fully utilize our net operating loss carryforwards of approximately \$23.0 million, (b) the risk of unseasonable weather and other factors in a single geographic region, New England, where our stores are concentrated, (c) the risk of being so dependent upon a single season, Halloween, for a significant amount of annual sales and profitability and (d) the risk of rising prices for petroleum products, which are a key raw material for much of our merchandise and which affect our freight costs and those of our suppliers and affect our customers' spending levels and patterns, (4) the risk that costs of opening new stores will put pressure on our profit margins until these stores reach maturity, (5) the risk that investment in infrastructure will increase our costs and (6) the expected costs of increased regulatory compliance, including, without limitation, those associated with Section 404 of the Sarbanes-Oxley Act, will likely have a negative impact on our profitability.

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

We adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN 48") on December 31, 2006. At the adoption date and as of September 29, 2007, we had no material unrecognized tax benefits and no adjustments to liabilities, retained earnings or operations were required.

We recognize interest and penalties related to uncertain tax positions in income tax expense which were zero for the nine months ended September 29, 2007.

Tax years 2004 through 2006 are subject to examination by the federal and state taxing authorities. There are no income tax examinations currently in process.

Stock Option Compensation Expense

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

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Our actual results could differ from our estimates.

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Fair Value Measurements

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

New Accounting Pronouncements

No new accounting pronouncements were issued during the quarter ended September 29, 2007 that are expected to have a material impact on our financial position or results of operations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There has been no material change in our market risk exposure since the filing of our Annual Report on Form 10-K.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* The Chief Executive Officer and the Chief Financial Officer of iParty (its principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of September 29, 2007, the end of the fiscal quarter to which this report relates, that iParty's disclosure controls and procedures: are effective to ensure that information required to be disclosed by iParty in the reports filed or submitted by it under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and include controls and procedures designed to ensure that information required to be disclosed by iParty in such reports is accumulated and communicated to iParty's management, including the Chief Executive Officer and the Chief Financial Officer, to allow timely decisions regarding required disclosure. iParty's disclosure controls and procedures are designed to provide a reasonable level of assurance of reaching iParty's disclosure requirements and are effective in reaching that level of reasonable assurance.

(b) *Changes in Internal Controls.* No change in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) occurred during the fiscal quarter ended September 29, 2007 that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

In addition to the risk factors previously disclosed in Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 30, 2006, as filed with the SEC on March 19, 2007, set forth below are additions and updates to those risk factors:

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

Our success depends in large part on the efforts and abilities of our senior management team. Their skills, experience and industry contacts significantly benefit our operations and administration. The failure to attract, retain, and properly motivate the members of our senior management team and other key employees, or to find suitable replacements for them in the event of death, ill health, or their desire to pursue other professional opportunities, could have a negative effect on our operating results. At the present time our President, Patrick Farrell, is transitioning his duties to other members of management in connection with his relocation to New York for personal family reasons and we will not be extending the term of his service. As previously disclosed, his regular employment with us will terminate on November 15, 2007. Our business performance and operating results will depend on our ability to successfully execute this transition process.

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

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

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

new stores in markets where we already have a presence so we can take advantage of economies of scale in marketing, distribution and supervision costs. However, these new stores may result in the loss of sales in existing stores in nearby areas, which could adversely affect our business and financial performance. In addition, future store openings could cause us, among other things, to incur additional debt, increased interest expense, as well as experience dilution in earnings, if any, per share. Impairment losses could also occur as a result of new store openings in the event that new store openings prove unsuccessful, or in the event that we determine to close underperforming stores.

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

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

As of September 29, 2007 there were 28,302,342 potential additional common share equivalents outstanding. These included 15,550,121 shares issuable upon the conversion of immediately convertible preferred stock, 2,083,334 shares issuable upon the exercise of a warrant with an exercise price of \$0.475, 528,210 shares issuable upon the exercise of warrants with a weighted average exercise price of \$3.79 and 10,140,667 shares issuable upon the exercise of stock options with a weighted average exercise price of \$0.59.

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

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

Not applicable.

Item 3. Defaults upon Senior Securities

Not applicable.

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

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: October 31, 2007

EXHIBIT INDEX

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