

IPARTY CORP  
Form 10-K/A  
May 27, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-K/A\***

(Amendment No. 1)

ý

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

For the fiscal year ended December 25, 2004

or

o

**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)

---

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common stock, \$.001 par value	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Exchange Act: **None**

## Edgar Filing: IPARTY CORP - Form 10-K/A

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

On June 26, 2004, the aggregate market value of the voting common equity of the registrant (consisting of common stock, \$.001 par value (the common stock)) held by nonaffiliates of the registrant was approximately \$14,091,685 based on the closing price for such common stock on said date as reported by the American Stock Exchange. As of March 21, 2005 there were 22,115,239 shares of common stock, \$.001 par value, outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the proxy statement for the annual stockholders' meeting to be held June 8, 2005 are incorporated by reference into Part III.

---

\* Amendment to Part II, Item 8 and Part IV, Item 15, as set forth herein.

---

**Explanatory Note to Form 10-K/A**

We are filing this Amendment No. 1 to our Annual Report on Form 10-K for the fiscal year ended December 25, 2004 to resubmit the Report of Independent Registered Public Accounting Firm so that it complies with PCAOB Auditing Standard No. 1. We have been advised by the SEC that it is no longer appropriate to refer to auditing standards as "generally accepted" in the United States. Instead, the audit report should have described the PCAOB's standards as "the standards of the Public Company Accounting Oversight Board (United States)". Also, the first paragraph of the opinion of Ernst & Young LLP has been revised to state that the related consolidated statements of operations, convertible preferred stock and stockholders' equity (deficit) and cash flows were audited for the three years in the period ended December 25, 2004 as opined by them in the last paragraph. In accordance with the rules of the SEC, the full text of the affected Item 8 and Item 15 of the original filing on Form 10-K are included in this amendment and the certifications mandated under the Sarbanes-Oxley Act of 2002 are hereby submitted as of the date hereof.

Amendment No. 1 also corrects an inadvertent error in the cover page: the box for disclosure of delinquent filers pursuant to Item 405 of Regulation S-K should not have been checked.

This Form 10-K/A does not amend, modify or update any other information.

---

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The response to this Item is included in a separate section of this report. See Index to Consolidated Financial Statements on page F-1.

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K**

(a) 1. Financial statements:

For a listing of consolidated financial statements which are included in this document, see page F 1.

2. Financial Statement Schedules:

All schedules for which provision is made in the applicable accounting regulation of the SEC are not required under the related instructions or are inapplicable and, therefore, have been omitted.

3. Exhibits:

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

(b) Exhibits:

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

(c) Financial Statement Schedules:

Included in Item 15(a)(2) above.



**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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*

Dated: May 27, 2005

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
<i>/s/ SAL PERISANO</i> Sal Perisano	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	May 27, 2005
<i>/s/ PATRICK FARRELL</i> Patrick Farrell	President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	May 27, 2005
<i>/s/ DANIEL DE WOLF</i> Daniel De Wolf	Director	May 27, 2005
<i>/s/ FRANK HAYDU</i> Frank Haydu	Director	May 27, 2005
<i>/s/ LORENZO ROCCIA</i> Lorenzo Roccia	Director	May 27, 2005
<i>/s/ ERIC SCHINDLER</i> Eric Schindler	Director	May 27, 2005
<i>/s/ JOSEPH VASSALLUZZO</i> Joseph Vassalluzzo	Director	May 27, 2005
<i>/s/ CHRISTINA WEAVER-VEST</i> Christina Weaver-Vest	Director	May 27, 2005

**iPARTY CORP.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Operations

Consolidated Statements of Convertible Preferred Stock and Stockholders' Equity (Deficit)

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

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

F-1

---



**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

iParty Corp.

We have audited the accompanying consolidated balance sheets of iParty Corp. and subsidiaries as of December 25, 2004 and December 27, 2003, and the related consolidated statements of operations, convertible preferred stock and stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 25, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of iParty Corp. and subsidiaries at December 25, 2004 and December 27, 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 25, 2004, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Boston, Massachusetts  
February 24, 2005

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

## iPARTY CORP.

## CONSOLIDATED BALANCE SHEETS

	Dec 25, 2004	Dec 27, 2003
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,757,157	\$ 2,442,471
Restricted cash	561,407	533,284
Accounts receivable	700,961	487,934
Inventory, net	11,400,971	9,423,463
Prepaid expenses and other assets	476,046	483,925
Total current assets	14,896,542	13,371,077
Property and equipment, net	4,483,705	1,694,140
Other assets	99,690	86,763
Total assets	\$ 19,479,937	\$ 15,151,980
<b>LIABILITIES AND STOCK AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 3,421,195	\$ 3,095,848
Accrued expenses	2,615,835	2,306,902
Current portion of capital lease obligations	365,674	29,220
Borrowings under line of credit	5,257,690	3,760,671
Total current liabilities	11,660,394	9,192,641
Long-term liabilities:		
Capital lease obligations, net of current portion	796,693	260
Other liabilities	471,759	406,209
Total long-term liabilities	1,268,452	406,469
Commitments and contingencies		
Stockholders equity:		
Convertible preferred stock - \$.001 par value; 10,000,000 shares authorized, Series A convertible preferred stock - 1,000,000 shares authorized, 0 and 1,000,000 issued and outstanding at December 25, 2004 and December 27, 2003, respectively (aggregate liquidation value of \$0 at December 25, 2004)		1,000,000
Series B convertible preferred stock - 1,150,000 shares authorized; 507,460 and 611,080 shares issued and outstanding at December 25, 2004 and December 27, 2003, respectively (aggregate liquidation value of \$10,149,200 at December 25, 2004)	7,551,002	9,092,870
Series C convertible preferred stock - 100,000 shares authorized, issued and outstanding (aggregate liquidation value of \$2,000,000 at December 25, 2004)	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 December 25, 2004)	3,652,500	3,652,500
Series E convertible preferred stock - 533,333 shares authorized; 296,667 and 389,439 shares issued and outstanding at December 25, 2004 and December 27, 2003, respectively (aggregate liquidation value of \$1,112,500 at December 25, 2004)	1,112,500	1,460,396
Series F convertible preferred stock - 114,286 shares authorized, issued and outstanding (aggregate liquidation value of \$500,000 at December 25, 2004)	500,000	500,000
Total convertible preferred stock	14,308,002	17,197,766
Common stock - \$.001 par value; 150,000,000 shares authorized; 22,092,717 and 18,780,204 shares issued and outstanding at December 25, 2004 and December 27, 2003, respectively	22,093	18,780

Edgar Filing: IPARTY CORP - Form 10-K/A

Additional paid-in capital	50,448,100	47,554,621
Accumulated deficit	(58,227,104)	(59,218,297)
Total stockholders' equity	6,551,091	5,552,870
Total liabilities and stockholders' equity	\$ 19,479,937	\$ 15,151,980

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

F-3

---

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

	<b>Dec 25, 2004</b>	<b>For the twelve months ended</b>		<b>Dec 28, 2002</b>
		<b>Dec 27, 2003</b>		
Revenues	\$ 64,276,225	\$ 56,697,246		\$ 52,177,923
Operating costs:				
Cost of products sold	35,826,820	31,758,625		30,420,475
Marketing and sales	21,176,925	18,363,193		16,527,832
General and administrative	6,335,067	5,516,273		5,245,867
Special charge				396,465
Operating income (loss)	937,413	1,059,155		(412,716)
Other income	382,500			
Income (loss) before income taxes	1,319,913	1,059,155		(412,716)
Interest income	1,354	1,262		9,045
Interest expense	(225,074)	(212,227)		(280,898)
Income (loss) before income taxes	1,096,193	848,190		(684,569)
Income taxes	105,000	97,233		
Net income (loss)	\$ 991,193	\$ 750,957		\$ (684,569)
Net income (loss) available to common stockholders	\$ 991,193	\$ 750,957		\$ (774,719)
Income (loss) per share:				
Basic	\$ 0.03	\$ 0.02		\$ (0.04)
Diluted	\$ 0.02	\$ 0.02		\$ (0.04)
Income (loss) per share available to common stockholders:				
Basic	\$ 0.03	\$ 0.02		\$ (0.05)
Diluted	\$ 0.02	\$ 0.02		\$ (0.05)
Weighted-average shares outstanding:				
Basic	37,649,400	36,683,142		16,219,436
Diluted	41,517,036	38,868,484		16,219,436

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

## IPARTY CORP.

## CONSOLIDATED STATEMENTS OF CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY DEFICIT)

	Convertible Preferred Stock		Convertible Preferred Stock		Stockholders Common Stock		Equity (Deficit) Additional Paid-In	Accumulated	Total Stockholders Equity (Deficit)
	Shares	Amount	Shares	Amount	Shares	Amount	Capital	Deficit	
Balance December 29, 2001	3,274,372	\$ 20,092,667		\$	15,122,675	\$ 15,123	\$ 44,395,314	\$ (59,194,535)	\$ (14,784,098)
Issuance of common stock upon conversion of Series B convertible preferred stock	(119,786)	(1,257,886)			1,197,860	1,198	1,256,688		1,257,886
Issuance of common stock upon conversion of Series E convertible preferred stock	(66,666)	(250,000)			666,660	667	249,333		250,000
Series B convertible preferred stock adjustment	(313,974)	(314)					314		314
Series C convertible preferred stock adjustment	(45,198)	(45)					45		45
Series D convertible preferred stock adjustment	(112,996)	(113)					113		113
Equity portion of special charge							171,465		171,465
Exercise of stock options					9,375	9	4,679		4,688
Convertible preferred stock beneficial conversion dividend							90,150	(90,150)	
Net loss								(684,569)	(684,569)
Balance December 28, 2002	2,615,752	18,584,309			16,996,570	16,997	46,168,101	(59,969,254)	(13,784,156)
Issuance of common stock upon conversion of Series B convertible preferred stock	(73,719)	(1,096,939)			948,690	948	1,095,991		1,096,939
Issuance of common stock upon conversion of Series E convertible preferred stock	(77,228)	(289,604)			823,944	824	288,780		289,604
	(1,000,000)	(1,000,000)	1,000,000	1,000,000					1,000,000

Edgar Filing: IPARTY CORP - Form 10-K/A

Reclassification of Series A convertible preferred stock (Note 1)									
Reclassification of Series B convertible preferred stock (Note 1)	(611,080)	(9,092,870)	611,080	9,092,870					9,092,870
Reclassification of Series C convertible preferred stock (Note 1)	(100,000)	(1,492,000)	100,000	1,492,000					1,492,000
Reclassification of Series D convertible preferred stock (Note 1)	(250,000)	(3,652,500)	250,000	3,652,500					3,652,500
Reclassification of Series E convertible preferred stock (Note 1)	(389,439)	(1,460,396)	389,439	1,460,396					1,460,396
Reclassification of Series F convertible preferred stock (Note 1)	(114,286)	(500,000)	114,286	500,000					500,000
Exercise of stock options				11,000	11	1,749			1,760
Net income							750,957		750,957
Balance December 27, 2003			2,464,805	17,197,766	18,780,204	18,780	47,554,621	(59,218,297)	5,552,870
Issuance of common stock upon conversion of Series A convertible preferred stock			(1,000,000)	(1,000,000)	1,000,000	1,000	999,000		
Issuance of common stock upon conversion of Series B convertible preferred stock			(103,620)	(1,541,869)	1,333,693	1,333	1,540,536		
Issuance of common stock upon conversion of Series E convertible preferred stock			(92,772)	(347,895)	961,025	961	346,934		
Exercise of stock options					17,795	19	7,009		7,028
Net income							991,193		991,193
Balance December 25, 2004	\$		1,268,413	\$ 14,308,002	22,092,717	\$ 22,093	\$ 50,448,100	\$ (58,227,104)	\$ 6,551,091

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

## iPARTY CORP.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Dec 25, 2004	For the twelve months ended Dec 27, 2003	Dec 28, 2002
<b>Operating activities:</b>			
Net income (loss)	\$ 991,193	\$ 750,957	\$ (684,569)
Adjustments to reconcile net income (loss) to net cash provided by used in operating activities:			
Depreciation and amortization	634,250	601,015	633,173
Non-cash portion of special charge			171,465
Deferred rent	65,550	(22,723)	102,518
Changes in operating assets and liabilities:			
Accounts receivable	(213,027)	(41,946)	95,715
Inventory	(1,977,508)	(506,799)	366,188
Prepaid expenses and other assets	191,345	55,351	36,541
Accounts payable	325,347	343,537	116,151
Accrued expenses and other liabilities	112,540	189,406	(255,252)
Net cash provided by operating activities	129,690	1,368,798	581,930
<b>Investing activities:</b>			
Purchase of property and equipment	(2,121,134)	(1,166,258)	(775,147)
Net cash used in investing activities	(2,121,134)	(1,166,258)	(775,147)
<b>Financing activities:</b>			
Net borrowings under line of credit	1,497,019	283,933	121,761
Decrease (increase) in restricted cash	(28,123)	(161,332)	296,005
Principal payments on capital lease obligations	(169,794)	(210,773)	(301,978)
Proceeds from exercise of stock options	7,028	1,760	4,688
Net cash provided by (used in) financing activities	1,306,130	(86,412)	120,476
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(685,314)</b>	<b>116,128</b>	<b>(72,741)</b>
<b>Cash and cash equivalents, beginning of year</b>	<b>2,442,471</b>	<b>2,326,343</b>	<b>2,399,084</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$ 1,757,157</b>	<b>\$ 2,442,471</b>	<b>\$ 2,326,343</b>
Supplemental disclosure of non-cash financing activities:			
Conversion of Series A convertible preferred stock to common stock	\$ 1,000,000	\$	\$
Conversion of Series B convertible preferred stock to common stock	1,541,869	1,096,939	1,257,886
Conversion of Series E convertible preferred stock to common stock	347,895	289,604	250,000
Total conversion of convertible preferred stock to common stock	\$ 2,889,764	\$ 1,386,543	\$ 1,507,886
Acquisition of assets under capital lease	\$ 1,302,681	\$	\$ 7,881

Edgar Filing: IPARTY CORP - Form 10-K/A

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

F-6

---



**iPARTY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 25, 2004**

**1. THE COMPANY**

*Background*

The Company's efforts are devoted to the sale of party goods and services through its retail stores. At the end of fiscal 2004 the Company had 40 retail stores located throughout New England, with four additional stores located in Florida. In 2003, the Company licensed its Internet business to a third party in exchange for royalties under a license agreement, which to date have not been significant. Previously, the Company operated the Internet business with the same party under a fulfillment agreement.

The stores feature over 20,000 products ranging from greeting cards and balloons to more unique merchandise such as piñatas, gag gifts, masquerade and Hawaiian Luau items. The Company's sales are driven by the following events: Halloween, Christmas, Easter, Valentine's Day, New Year's, Independence Day, St. Patrick's Day, Thanksgiving, and Chanukah. The Company also focuses its business closely on lifetime events such as anniversaries, graduations, birthdays, and bridal or baby showers. The Company's business has a seasonal pattern with higher revenues in the second and fourth quarters, reflecting school graduations and Halloween, respectively.

*Management's Plans*

The Company believes, based on its current operating plan, that anticipated revenues from operations and borrowings available under the existing line of credit will be sufficient to fund its operations and working capital requirements through the next twelve months. The Company's current operating plan includes opening up to seven additional new stores in 2005, including the one new store that the Company opened since the end of fiscal 2004. In the event that the Company's operating plan changes or proves inaccurate due to decreased revenues, unanticipated expenses, increased competition, unfavorable economic conditions or other unforeseen circumstances, the Company's liquidity may be negatively impacted. Accordingly, the Company would be required to adjust its expenditures in 2005 to conserve working capital or raise additional capital to fund operations. There can be no assurance, however, that, should the Company require additional financing, such financing will be available on terms and conditions acceptable to the Company.

**2. SIGNIFICANT ACCOUNTING POLICIES:**

*Principles of Consolidation*

## Edgar Filing: IPARTY CORP - Form 10-K/A

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 and is not overly dependent upon any single source for its merchandise, often using more than one vendor for similar kinds of products.

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

*Use of Estimates*

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

*Cash and Cash Equivalents, Outstanding Checks 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 money market accounts and are carried at cost plus accrued interest, which approximates fair value.

The Company uses controlled disbursement banking arrangements as part of its cash management program. Outstanding checks, which were included in accounts payable, totaled \$950,156 at December 25, 2004 and \$989,816 at December 27, 2003. The Company had sufficient funds available to fund the outstanding checks when they were presented for payment.

Restricted cash represents money deposited in blocked accounts 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 its line of credit approximates carrying value because the debt bears interest at a variable market rate.

*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.

## Edgar Filing: IPARTY CORP - Form 10-K/A

The Company also makes adjustments to reduce the value of its inventory for an allowance for obsolete and excess inventory, which is based on its review of inventories on hand compared to estimated future sales.

In 2003, the Company refined its methodology for accounting for vendor rebates, discounts and freight. The net impact of these adjustments increased pre-tax income by \$141,757, net income by \$125,455 and had no impact on net income per basic and diluted share.

### *Advertising*

Advertising costs are expensed upon first showing. Advertising costs amounted to \$3,174,446, \$2,706,596, and \$2,705,330 for the years ended December 25, 2004, December 27, 2003 and December 28, 2002, respectively.

### *Deferred Rent*

Certain operating lease agreements contain scheduled rent increases, which are being amortized over the terms of the agreements using the straight-line method, and are included in other liabilities in the accompanying consolidated balance sheet. Deferred rent was \$471,759 at December 25, 2004 and \$406,209 at December 27, 2003.

*Net Income (Loss) per Share*

Net income per basic share is computed by dividing net income by the weighted-average number of common shares outstanding plus the common share equivalents of Series B-F preferred stock. The common share equivalents of Series B-F are included in the calculation of net income 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 the periods with net losses, the Company excludes those common share equivalents since their impact would be anti-dilutive.

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

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

	2004		2003		2002	
Net income (loss)	\$	991,193	\$	750,957	\$	(684,569)
Preferred stock beneficial conversion feature						(90,150)
Net income (loss) available to common stockholders	\$	991,193	\$	750,957	\$	(774,719)
Net income (loss) per share available to common stockholders						
Basic	\$	0.03	\$	0.02	\$	(0.05)
Diluted	\$	0.02	\$	0.02	\$	(0.05)
Weighted-average shares outstanding:						
Common shares		21,364,673		17,652,805		16,219,436
Common share equivalents of Series B-F convertible preferred stock		16,284,727		19,030,337		
Basic weighted-average shares outstanding		37,649,400		36,683,142		16,219,436
Common share equivalents of Series A convertible preferred stock		48,077		1,000,000		
Common share equivalents of in the money stock options		3,819,559		1,185,342		
Common share equivalents of in the money warrants						
Diluted weighted-average shares outstanding		41,517,036		38,868,484		16,219,436

The common share equivalents of out of the money stock options and warrants which were excluded from the computation of net income per diluted share available to common stockholders were 3,309,630 and 13,011,215 in 2004, respectively, and 2,157,980 and 13,563,212 in 2003, respectively.

*Stock Option Compensation Expense*

Edgar Filing: IPARTY CORP - Form 10-K/A

The Company accounts for its stock option compensation agreements with employees under the provisions of Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards ( SFAS ) 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*.

The Company has computed the value of options using the Black-Scholes option pricing model prescribed by SFAS No. 123. The weighted-average fair value of the options granted was \$0.73 per share in 2004, \$0.38 per share

F-9

---

## Edgar Filing: IPARTY CORP - Form 10-K/A

during 2003 and \$0.29 per share during 2002, using the Black-Scholes option-pricing model with the following assumptions: no dividend yield, volatility of 116% to 119% in 2004, 119% to 125% in 2003, and 125% in 2002, a risk-free interest rate of 2.71% to 4.00% in 2004, 2.13% to 3.51% in 2003 and 4.86% to 5.95% in 2002, and an expected life of five years from date of the grant. Had compensation cost for the Company's stock option plan been determined based upon the fair value at the grant date for awards under the plan consistent with the methodology prescribed under SFAS 123, the Company's net income (loss) and net income (loss) per share and net income (loss) available to common stockholders and net income (loss) per share available to common stockholders would have been the following pro forma amounts:

	2004		2003		2002
<b>Net income (loss):</b>					
Reported	\$ 991,193	\$	750,957	\$	(684,569)
Stock option compensation expense	(668,223)		(480,268)		(671,029)
Pro forma	\$ 322,970	\$	270,689	\$	(1,355,598)
<b>Net income (loss) per basic share:</b>					
Reported	\$ 0.03	\$	0.02	\$	(0.04)
Pro forma	\$ 0.01	\$	0.01	\$	(0.08)
<b>Net income (loss) per diluted share:</b>					
Reported	\$ 0.02	\$	0.02	\$	(0.04)
Pro forma	\$ 0.01	\$	0.01	\$	(0.08)
<b>Net income (loss) available to common stockholders:</b>					
Reported	\$ 991,193	\$	750,957	\$	(774,719)
Stock option compensation expense	(668,223)		(480,268)		(671,029)
Pro forma	\$ 322,970	\$	270,689	\$	(1,445,748)
<b>Net income (loss) per basic share available to common stockholders:</b>					
Reported	\$ 0.03	\$	0.02	\$	(0.05)
Pro forma	\$ 0.01	\$	0.01	\$	(0.09)
<b>Net income (loss) per diluted share available to common stockholders:</b>					
Reported	\$ 0.02	\$	0.02	\$	(0.05)
Pro forma	\$ 0.01	\$	0.01	\$	(0.09)

### *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. At the beginning of fiscal 2004 the Company adopted a new policy for estimating the useful life of fixed assets which extended the useful life of equipment and furniture and fixtures. Changing the estimated life of the assets in these categories as of the beginning of the year reduced depreciation expense by approximately \$130,885. Net income in 2004 would have been \$0.02 per basic and diluted share if this change in estimating the useful life of fixed assets had not been adopted. 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





*Accounting for the Impairment of Long-Lived Assets*

The Company adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in fiscal 2002, which requires that long-lived assets be measured at the lower of carrying amount or fair value less cost to sell. The adoption of SFAS No. 144 did not have a material impact on the Company's consolidated results of operations.

*New Accounting Pronouncements*

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51 (FIN 46)*. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. However, in October 2003, the FASB deferred the effective date of FIN 46 to the end of the first interim or annual period ending after December 15, 2003 for those arrangements involving special purpose entities entered into prior to February 1, 2003. All other arrangements within the scope of FIN 46 are subject to its provisions beginning in 2004. The Company adopted FIN 46, as required, with no material impact to its consolidated financial position or results of operations.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

SFAS 123(R) must be adopted by the Company no later than July 1, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. The Company expects to adopt SFAS 123(R) on July 1, 2005.

SFAS 123(R) permits public companies to adopt its requirements using one of two methods:

A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.

A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company has not yet determined which method it will use.

As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS 123(R)'s fair value method will have a significant impact on the Company's results of operations, although it will have no impact on its overall financial position. The impact of adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted SFAS 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net loss and net loss per share discussed above.

*Reclassifications*

Certain reclassifications have been made to prior year's amounts to conform to the current year presentation.

**3. PROPERTY AND EQUIPMENT:**

Property and equipment consist of the following:

	Dec 25, 2004	Dec 27, 2003
Leasehold improvements	\$ 2,017,339	\$ 996,460
Furniture and fixtures	1,798,389	860,982
Equipment under capital leases	1,321,160	289,737
Computer hardware and software	728,946	401,598
Equipment	446,680	339,922
Property and equipment	6,312,514	2,888,699
Less accumulated depreciation	(1,828,809)	(1,194,559)
Property and equipment, net	\$ 4,483,705	\$ 1,694,140

**4. LEASES:**

The Company conducts its operations in leased facilities with certain leased equipment accounted for as operating and capital leases. Real estate leases generally provide for fixed minimum rentals, which typically increase periodically during the life of the lease, and, in some instances, contingent rentals based on a percentage of sales in excess of specified minimum sales levels, as well as occupancy costs, such as property taxes and common area maintenance. The leases are typically for 10 years, usually with options from the Company's landlords to renew the Company's leases for an additional 5 or 10 years.

The original cost of assets under capital leases at December 25, 2004 and December 27, 2003 was \$1,321,161 and \$289,737, respectively. The accumulated depreciation of assets under capital leases at December 25, 2004 and December 27, 2003 was \$132,631 and \$286,847, respectively. The amortization related to those assets under capital lease is included in depreciation expense.

At December 25, 2004 the minimum rental commitments under all non-cancelable capital and operating leases with initial or remaining terms of more than one year were as follows:

Year	Capital	Operating
2005	\$ 490,561	\$ 7,223,873
2006	501,942	6,949,341

Edgar Filing: IPARTY CORP - Form 10-K/A

2007	323,784	5,642,420
2008		4,293,303
2009		4,104,859
Thereafter		14,601,593
Total future minimum lease payments	1,316,287	\$ 42,815,389
Less amount representing interest	153,920	
Present value of minimum lease payments	1,162,367	
Less current portion of obligation under capital leases	365,674	
Long-term obligation under capital leases	\$	796,693

F-12

## Edgar Filing: IPARTY CORP - Form 10-K/A

The Company's rental expense under operating leases amounted to \$6,431,752 in 2004, \$5,323,409 in 2003 and \$4,746,886 in 2002. Included in these amounts are contingent rentals totaling \$45,039 in 2004, \$37,948 in 2003 and \$24,941 in 2002.

### 5. ACCRUED EXPENSES:

There was no accrued expense which exceeded 5% of current liabilities on the balance sheet at December 25, 2004. The only accrued expense which exceeded 5% of current liabilities on the balance sheet at December 27, 2003 was accrued payroll and benefits of \$461,204.

### 6. INCOME TAXES:

A reconciliation of the effective rate with the federal statutory rate is as follows:

	2004	2003	2002
Federal statutory rate	34.0%	34.0%	-34.0%
State income taxes, net of federal benefit	5.1%	5.2%	-6.0%
Permanent differences	1.7%	1.1%	10.0%
Change in valuation allowance	-31.2%	-28.8%	30.0%
Effective tax rate	9.6%	11.5%	0.0%

Deferred tax assets consist of the following:

	2004	2003
Net operating loss carryforwards	\$ 8,732,000	\$ 9,436,000
Inventory reserves	503,000	557,000
Deferred rent	186,000	162,000
Accrued vacation	103,000	90,000
Other	91,000	40,000
Excess book over tax depreciation and amortization	60,000	156,000
	9,675,000	10,441,000
Less valuation allowance	(9,675,000)	(10,441,000)
Net deferred tax asset	\$	\$

The Company has recorded a valuation allowance against its deferred tax assets because of the uncertainty regarding the realizability of these assets against future taxable income.

The Company used approximately \$923,000 and \$792,000 of net operating loss carryforwards in 2004 and 2003, respectively.

Edgar Filing: IPARTY CORP - Form 10-K/A

As of December 25, 2004, the Company has 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 some of these carryforwards will be subject to annual limitations based upon ownership changes of the Company's stock which may have occurred or that may occur.

The Company made cash payments for state income taxes of \$157,752 in 2004, \$77,279 in 2003 and \$16,500 in 2002. The Company made cash payments for federal income taxes of \$35,000 in 2004, \$0 in 2003 and \$0 in 2002.

F-13

---

## 7. CONTRACTUAL ARRANGEMENTS:

### *License Arrangement*

On July 8, 1999, the Company entered into a product fulfillment agreement with Taymark, a direct marketer of party supplies, to utilize the direct marketer's inventory and fulfillment services to deliver merchandise ordered on the Company's website, or directly through a toll-free telephone number, to consumers.

On July 8, 2003 the Company signed a new agreement with Taymark to license the iParty.com name to Taymark, which now operates the website at www.iparty.com. In return, Taymark pays the Company a 15% royalty on all net sales realized through its operation of www.iparty.com. The term of this agreement is for a period of two (2) years, unless sooner terminated. If this agreement is not terminated, it shall be automatically renewed for successive one-year periods.

### *Earn-out agreement*

The Company purchased from The Big Party, Debtor and Debtor-in-Possession (the sellers) in 2000 inventory, fixed assets and the leases of 33 retail stores in consideration of cash and assumption of certain liabilities. In addition, the Company agreed to pay the sellers, no later than March 31, 2004, an amount equivalent to the greater of \$250,000, or a percentage of the aggregate operating results of the 33 acquired locations. In connection with the Company's purchase accounting in 2000, the Company accrued the guaranteed amount of \$250,000, which based on actual results is the minimum and final amount due as of December 27, 2003, and paid this amount during the first quarter of 2004.

## 8. RELATED PARTY TRANSACTIONS:

On August 26, 1999 the Company granted Mr. Sal Perisano, its Chief Executive Officer, options to purchase an aggregate of 434,730 shares of the Company's common stock pursuant to the Company's stock option plan with an exercise price of \$2.00, which was below the then-current market price of \$3.38. As of December 29, 2001 all such options had vested. These options were fully expensed as of December 29, 2001. The Company charged \$273,971 related to this stock option grant to stock option compensation expense in 2001, the final year of vesting.

On September 7, 1999, the Company and Mr. Stuart Moldaw, who served as a Director of the Company from 1999 to 2003, entered into a consulting agreement that had a term of three years. Upon the expiration of this agreement, the Company and Mr. Moldaw entered into an oral agreement that Mr. Moldaw would continue to provide consulting services to the Company. On November 6, 2003 the Compensation Committee of the Company's Board of Directors approved a stock option grant to Mr. Moldaw, vesting immediately, with the strike price set at the closing price of the Company's common stock on that day, to purchase 50,000 shares of common stock, for consulting services performed by Mr. Moldaw in 2003. The fair value of the options granted to Mr. Moldaw on November 6, 2003 was \$25,000. On January 31, 2005 the Compensation Committee of the Company's Board of Directors approved a stock option grant to Mr. Moldaw, vesting immediately, with the strike price set at the closing price of the Company's common stock on that day, to purchase 50,000 shares of common stock, for consulting services performed by Mr. Moldaw in 2004. The fair value of the options granted on January 31, 2005 was \$28,500. The committee approved this grant, but noted that Mr. Moldaw would not receive any additional stock option grants for consulting services in the future.

**9. LINE OF CREDIT:**

On January 2, 2004 the Company amended its existing line of credit ( the line ) with Wells Fargo Retail Finance II, LLC. The amendment extended the maturity date of the line to January 2, 2007, eliminated the minimum interest rate of 6.5%, established a new interest rate at the bank's base rate plus 50 basis points and added the option to increase the line in increments of \$2,500,000 beyond the previous limit of \$7,500,000, to a limit of \$12,500,000, upon 15 days written notice, as long as the Company is in compliance of all debt covenants and the provisions of the loan agreement. Inventory and accounts receivable secure the Company's line.

F-14

---



The amended agreement includes a financial covenant requiring the Company to maintain a minimum availability under the line of 5% of the credit limit, which at the current limit of \$7,500,000, is \$375,000. If the Company adjusts the credit limit in the future, the minimum availability would be 5% of the adjusted credit limit. The amended agreement 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. At December 25, 2004, the Company was in compliance with these financial covenants. The line generally prohibits the payment of any dividends or other distributions to any of the Company's classes of capital stock.

At December 27, 2003 the line had a maturity date of July 31, 2004 and a minimum interest rate of 6.5%. The line allowed for borrowings equal to the lesser of \$7,500,000 or the borrowing base, as defined. Inventory and other assets secured the line. The Company was required to maintain a minimum availability under the line in the amount of \$300,000.

The amounts outstanding under the line as of December 25, 2004 and December 27, 2003 were \$5,257,690 and \$3,760,671, respectively. The interest rate on these borrowings was 5.75% at December 25, 2004 and 6.5% at December 27, 2003. The outstanding balances under the line 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 December 25, 2004, the Company had approximately \$305,000 of additional availability under the line. In the third quarter of fiscal 2004, the Company established a letter of credit for \$356,000 with Wells Fargo Bank, N.A. associated with the leasing of its new point-of-sale system. This \$356,000 letter of credit was outstanding at December 25, 2004.

The Company made cash payments for interest of \$218,765 in 2004, \$217,268 in 2003, and \$285,515 in 2002.

## 10. PREFERRED STOCK:

The following table summarizes the changes in the number of shares of convertible preferred stock during the past two years.

	Shares Issued and Outstanding as of 12/25/04	Conversions to Common Stock	Shares Issued and Outstanding as of 12/27/03	Conversions to Common Stock	Shares Historically Reported as Issued and Outstanding as of 12/28/02
Series A convertible preferred stock		(1,000,000)	1,000,000		1,000,000
Series B convertible preferred stock	507,460	(103,620)	611,080	(73,719)	684,799
Series C convertible preferred stock	100,000		100,000		100,000
Series D convertible preferred stock	250,000		250,000		250,000
Series E convertible preferred stock	296,667	(92,772)	389,439	(77,228)	466,667
Series F convertible preferred stock	114,286		114,286		114,286
Total	1,268,413	(1,196,392)	2,464,805	(150,947)	2,615,752

On October 31, 2002, the Company concluded it had incorrectly applied the anti-dilution provisions of its Series B, C and D convertible preferred stock (the "Affected Preferred Stock") in conjunction with dilutive financings in August and September 2000. The Company determined that it inadvertently issued additional shares of Affected Preferred Stock, instead of adjusting the Affected Preferred Stock's conversion ratios. The Company also miscalculated the number of common shares issuable upon conversion of the Affected Preferred Stock. As a result of the above transactions, the anti-dilution provisions of the Company's Series E and Series F convertible preferred stock were also triggered,

Edgar Filing: IPARTY CORP - Form 10-K/A

increasing the number of shares issuable upon conversion of the Company's Series E and Series F convertible preferred stock.

See Note 16 for additional information on this subject.

F-15

---

*Series A Convertible Preferred Stock*

On January 13, 2004, all shares of Series A convertible preferred stock were converted into 1,000,000 shares of common stock on a 1.00 to 1.00 ratio. Holders of Series A convertible preferred stock had a liquidation preference senior to the Company's common stockholders, and were *pari passu* with the Company's Series B, C, D, E and F convertible preferred stock. Until their shares of Series A convertible preferred stock were converted into shares of common stock, holders of Series A convertible preferred stock were not entitled to any dividends or to vote on matters submitted to a vote of the Company's stockholders, except to the extent otherwise expressly provided by the General Corporation Law of Delaware.

*Series B Convertible Preferred Stock*

The shares of Series B convertible preferred stock are immediately convertible into 6,531,105 shares of common stock on a 1.000 to 12.870 ratio at December 25, 2004, and carry an aggregate liquidation value of \$10,149,200 (\$1.55 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Certificate of Incorporation as amended at a price below the conversion price. The Series B convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the Company consummates a secondary public offering resulting in gross proceeds to the Company of at least \$10,000,000.

In the event of liquidation, the holders of Series B convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series C, D, E and F convertible preferred stock.

Holders of Series B convertible preferred stock are entitled to 12 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

*Series C Convertible Preferred Stock*

The shares of Series C convertible preferred stock are immediately convertible into 1,310,600 shares of common stock on a 1.000 to 13.106 ratio at December 25, 2004, and carry an aggregate liquidation value of \$2,000,000 (\$1.53 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series C convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the Company consummates a secondary public offering resulting in gross proceeds to the Company of at least \$10,000,000.

In the event of liquidation, the holders of Series C convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series B, D, E and F convertible preferred stock.

Holders of Series C convertible preferred stock are entitled to 13 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

*Series D Convertible Preferred Stock*

The shares of Series D convertible preferred stock are immediately convertible into 3,513,750 shares of common stock on a 1.000 to 14.055 ratio at December 25, 2004, and carry an aggregate liquidation value of

\$5,000,000 (\$1.42 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series D convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the Company consummates a secondary public offering resulting in gross proceeds to the Company of at least \$10,000,000.

In the event of liquidation, the holders of Series D convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series B, C, E and F convertible preferred stock.

Holders of Series D convertible preferred stock are entitled to 14 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

#### *Series E Convertible Preferred Stock*

The shares of Series E convertible preferred stock are immediately convertible into 3,073,168 shares of common stock on a 1.000 to 10.359 ratio at December 25, 2004, and carry an aggregate liquidation value of \$1,112,500 (\$0.36 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series E convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the average closing bid price of the common stock equals or exceeds \$10.00 per share for 20 days within any 30-day period.

In the event of liquidation, the holders of Series E convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series B, C, D and F convertible preferred stock.

Holders of Series E convertible preferred stock are entitled to 10 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

#### *Series F Convertible Preferred Stock*

The shares of Series F convertible preferred stock are immediately convertible into 1,184,803 shares of common stock on a 1.000 to 10.367 ratio at December 25, 2004, and carry an aggregate liquidation value of \$500,000 (\$0.42 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series F convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the average closing bid price of the common stock equals or exceeds \$10.00 per share for 20 days within any 30-day period.

In the event of liquidation, the holders of Series F convertible preferred stock have preference to holders of the Company's common stock, and are pari passu with the Company's Series B, C, D and E convertible preferred stock.

F-17

---

Holders of Series F preferred stock are entitled to 10 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

*Accretion of Dividends in the Event of Liquidation*

The carrying values of Series B-F convertible preferred stock have been determined based on their fair market values at the original dates of issuance. In certain cases, warrants were issued, which the Company allocated value to and included in additional paid in capital. Should such a liquidation event occur, the difference between the carrying value of the convertible preferred stock and their liquidation value will be accreted. This amount was \$4,453,698 on December 25, 2004.

**11. WARRANTS:**

At December 25, 2004, there were various warrants outstanding for shares of the Company's common stock. These warrants were issued in connection with certain preferred stock financings and certain licensing and marketing arrangements. Substantially all of the warrant agreements contain certain anti-dilution provisions, which protect the warrant holders against dilution upon the occurrence of certain events, including the sale of common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock, as defined in the warrant agreement for less than fair market value or less than the exercise price of the previously issued warrants. If such an event occurs, this can result in additional shares being available to the warrant holder and a reduction in the exercise price for each share.

The following table summarizes the Company's outstanding warrants, including the impact of anti-dilution events which occurred in previous years, at December 25, 2004:

Number of Warrants	Total Common Shares Issuable	Exercise Price per Common Share Issuable	Expiration Date
528,210	528,210	\$ 2.63 - \$5.13	04/16/09 - 08/15/09
5,223,512	8,357,619	1.25	08/26/05
500,000	800,000	1.25	08/26/05
929,929	1,487,886	1.25	08/26/05
1,250,000	1,837,500	1.36	08/26/05
8,431,651	13,011,215	1.37	

Commencing one year from the issue date, the Company may, at its option, on a 30-day notice, redeem certain common stock warrants at a price of \$0.05 per warrant if the average closing bid price of the common stock equals or exceeds \$8.00 per share for 20 days within any 30-day period.

**12. STOCK OPTION PLAN:**

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. Qualified incentive 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.



Edgar Filing: IPARTY CORP - Form 10-K/A

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

	Number of Stock Options	Weighted Average Exercise Price	Price Range
Outstanding - December 29, 2001	7,522,964	\$ 1.07	\$ 0.10 - \$ 5.38
Granted	863,457	0.33	0.21 - 0.67
Expired/Forfeited	(133,862)	0.31	0.10 - 0.50
Exercised	(9,375)	0.50	0.50 - 0.50
Outstanding - December 28, 2002	8,243,184	1.01	0.11 - 5.38
Granted	455,555	0.45	0.15 - 1.06
Expired/Forfeited	(170,021)	0.29	0.15 - 0.44
Exercised	(11,000)	0.16	0.16 - 0.16
Outstanding - December 27, 2003	8,517,718	0.99	0.11 - 5.38
Granted	1,801,300	0.89	0.69 - 1.33
Expired/Forfeited	(269,406)	1.50	0.11 - 4.00
Exercised	(17,795)	0.39	0.20 - 0.50
Outstanding - December 25, 2004	10,031,817	\$ 0.96	\$ 0.13 - \$ 5.38
Exercisable - December 25, 2004	8,210,070	\$ 1.01	\$ 0.13 - \$ 5.38
Available for grant - December 25, 2004	595,013		

The following table summarizes information for options outstanding and exercisable at December 25, 2004:

Price Range	Number of Stock Options	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Stock Options	Weighted Average Exercise Price
\$ 0.11 - \$ 0.20	244,860	6.9	\$ 0.18	187,396	\$ 0.18
0.21 - 0.30	3,832,882	6.2	0.25	3,592,078	0.25
0.31 - 0.50	1,092,768	7.2	0.35	980,726	0.35
0.51 - 1.00	2,882,177	8.1	0.80	1,497,515	0.74
1.01 - 3.50	989,130	4.7	2.17	962,355	2.19
3.51 - 5.38	990,000	4.4	3.82	990,000	3.82
Total	10,031,817	6.5	\$ 0.96	8,210,070	\$ 1.01

The Company has reserved 38,656,458 shares of common stock for issuance in connection with the conversion of convertible preferred stock and the exercise of warrants and stock options.

13. STOCKHOLDER RIGHTS PLAN:

Edgar Filing: IPARTY CORP - Form 10-K/A

The Company has a Stockholder Rights Plan (the Plan ) effective November 9, 2001. Under the Plan each share of the Company s capital stock outstanding at the close of business on November 9, 2001 and each share of the Company s capital stock issued subsequent to that date has a right associated with it, such that each share of its

F-19

---

common stock is entitled to one right and each share of its preferred stock is entitled to such number of rights equal to the number of common shares into which it is convertible.

The rights are exercisable only in the event, with certain exceptions, an acquiring party accumulates 10 percent or more of the Company's voting stock, or if a party announces an offer to acquire 15 percent or more of the Company's voting stock. The rights expire on November 9, 2011.

When exercisable, each right entitles the holder to purchase from the Company, one one-hundredth of a share of a new series of Series G junior preferred stock at an initial purchase price of \$2.00. In addition, upon the occurrence of certain events, holders of the rights will be entitled to purchase either iParty Corp. stock or shares in an acquiring entity at half of market value. The Company generally will be entitled to redeem the rights at \$0.001 per right at any time until the date on which a 10 percent position in its voting stock is acquired by any person or group. Until a right is exercised, the holder thereof, as such, will have no rights as a stockholder of the Company, including, without limitation, the right to vote or receive dividends.

#### **14. PROFIT SHARING 401(k) PLAN:**

The iParty 401(k) Plan is a qualified profit sharing plan covering substantially all of its employees. Contributions to this plan are at the discretion of the Board of Directors. The Company's expense, including matching contributions and any discretionary amounts was \$111,799 in 2004, \$95,405 in 2003 and \$88,532 in 2002.

#### **15. SEGMENT REPORTING:**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for the way business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to stockholders.

In the past the Company had determined that its reportable segments consisted of a retail stores operation and an Internet operation. As of 2003, with the transition of the Internet operation to a license arrangement and the insignificance of the revenues prior to the transition (less than 2%) and results of operations (less than 5%) to the overall business, the Company no longer reports Internet operating segment information.

#### **16. SPECIAL CHARGE:**

On October 31, 2002, the Company concluded it had incorrectly applied the anti-dilution provisions of its Series B, C and D convertible preferred stock (the Affected Preferred Stock) in conjunction with dilutive financings in August and September 2000.

## Edgar Filing: IPARTY CORP - Form 10-K/A

The Company determined that it inadvertently issued additional shares of Affected Preferred Stock, instead of adjusting the Affected Preferred Stock's conversion ratios. The Company also miscalculated the number of common shares issuable upon conversion of the Affected Preferred Stock.

The Company also reviewed the anti-dilution provisions of certain of its warrants to purchase common stock that were issued in conjunction with the Affected Preferred Stock (the Affected Warrants), and has determined that it mistakenly issued additional warrant certificates, instead of adjusting the Affected Warrants' conversion ratios. The warrant calculations also mistakenly omitted the dilutive effect of a warrant issued by the Company in December 1999.

The Company performed the calculations to compute the correct number of shares of Affected Preferred Stock and Affected Warrants that should be issued and outstanding as of December 28, 2002, along with the appropriate conversion ratios in effect at December 28, 2002. The Company notified each holder of Affected Preferred Stock as of December 2, 2002. The Company also instructed its transfer agent to apply any Affected Stock conversions using the corrected ratios and prices. The Company has presented its earnings per share and all footnotes information for 2002, in accordance with the corrected information. The accounting implications of this situation are as follows:

F-20

---

Beginning in September 2000, the Company believed and treated holders of Affected Preferred Stock as if they were entitled to approximately 2.3 million more common shares upon conversion of their Affected Preferred Stock than they were in fact entitled to. Of this overstated amount, 590,327 common shares were issued upon conversions of shares of Affected Preferred Stock and sold in the public market (the Overissued Shares ) beginning in October 2000. On October 31, 2002, the Company's Board of Directors ratified the issuance of the Overissued Shares.

Beginning in September 2000, the Company believed and treated holders of Affected Warrants as if they were entitled to 116,291 fewer common shares upon exercise of their Affected Warrants than they were in fact entitled to. None of the Affected Warrants have been exercised as of March 21, 2005.

The impact of these matters did not require the Company to make any changes to its previously reported earnings per share. The impact of the common stock equivalents did not affect quarterly or annual loss per diluted share, since such the inclusion of such shares would have been anti-dilutive. The impact of common stock equivalents did not impact quarterly net income per diluted share in such periods of profit, given the minimal amount of net income in comparison to the weighted-average shares outstanding.

The Company recorded a special charge for the year ended December 28, 2002 in the amount of \$396,465, which included a non-cash charge of \$171,465 for the recognition of the Overissued Shares, and \$225,000 of professional fees incurred through December 28, 2002.

The Company also recorded a beneficial conversion dividend in the amount of \$90,150 in the fourth quarter of 2002, which reflects the impact of anti-dilution adjustments to the conversion ratios of the Series E and F convertible preferred stock.

In 2004 the Company reached a settlement with a third party in connection with the special charge previously recorded in fiscal year 2002. The Company recorded the net settlement of \$382,500 as other income.

**17. QUARTERLY FINANCIAL DATA (UNAUDITED):****QUARTERLY FINANCIAL DATA**

	<b>Mar 27, 2004</b>		<b>Jun 26, 2004</b>		<b>Sep 25, 2004</b>		<b>Dec 25, 2004</b>	
Revenues	\$	12,036,066	\$	15,360,388	\$	13,157,546	\$	23,722,225
Cost of products sold (1), (2)		6,973,329		8,482,813		7,849,135		12,521,543
Operating income (loss)		(810,759)		494,417		(1,477,668)		2,731,423
Net income (loss)		(838,005)		805,852		(1,526,977)		2,550,323
Net income (loss) per share								
Basic	\$	(0.04)	\$	0.02	\$	(0.07)	\$	0.07
Diluted	\$	(0.04)	\$	0.02	\$	(0.07)	\$	0.06
Weighted-average shares outstanding:								
Basic		20,227,671		37,698,128		22,019,408		37,649,400
Diluted		20,227,671		41,834,415		22,019,408		41,468,959

	<b>Mar 27, 2003</b>		<b>Jun 28, 2003</b>		<b>Sep 27, 2003</b>		<b>Dec 27, 2003</b>	
Revenues	\$	10,287,577	\$	13,805,555	\$	11,878,460	\$	20,725,654
Cost of products sold (1), (3)		6,241,696		7,849,863		7,060,170		10,606,896
Operating income (loss)		(1,112,040)		408,242		(969,252)		2,732,205
Net income (loss)		(1,164,266)		351,777		(1,034,727)		2,598,173
Net income (loss) per share								
Basic	\$	(0.07)	\$	0.01	\$	(0.06)	\$	0.07
Diluted	\$	(0.07)	\$	0.01	\$	(0.06)	\$	0.06
Weighted-average shares outstanding:								
Basic		16,999,935		36,678,915		17,687,448		36,688,228
Diluted		16,999,935		37,747,608		17,687,448		41,091,732

(1) Cost of products sold consists of the cost of merchandise sold to customers and the occupancy costs for stores.

(2) The fourth quarter of 2004 included an estimated reduction of \$149,316 to the cost of products sold during the previous three quarters due to the completion of physical inventories, for which shortage had been estimated during the year.

(3) The fourth quarter of 2003 included an estimated reduction of \$145,983 to the cost of products sold during the previous three quarters due to the completion of physical inventories, for which shortage had been estimated during the year.

**EXHIBIT INDEX**

<b>EXHIBIT NUMBER</b>	<b>DESCRIPTION</b>
3.1 (1)	Restated Certificate of Incorporation of WSI Acquisition Corp. and Certificate of Merger by iParty Corp. into WSI Acquisition Corp.
3.2 (1)	Certificate of Designation of Series A Preferred Stock of WSI Acquisitions, Corp.
3.3 (2)	Certificate of Designation of Series B Preferred Stock of iParty Corp.
3.4 (2)	Certificate of Designation of Series C Preferred Stock of iParty Corp.
3.5 (4)	Certificate of Designation of Series D Preferred Stock of iParty Corp.
3.6 (6)	Certificate of Designation of Series E Preferred Stock of iParty Corp.
3.7 (12)	Certificate of Correction to Certificate of Designation of Series E Preferred Stock of iParty Corp.
3.8 (7)	Certificate of Designation of Series F Preferred Stock of iParty Corp.
3.9 (9)	Certificate of Designation of Series G Junior Preferred Stock of iParty Corp.
3.10 (1)	By-Laws of WSI Acquisition Corp., as amended.
4.1 (2)	Warrant Agreement between iParty Corp., Continental Stock Transfer & Trust Company and Commonwealth Associates, LP.
4.2 (2)	Warrant Agreement between iParty Corp., Continental Stock Transfer & Trust Company and Commonwealth Associates, LP.
4.3 (5)	Taymark Warrant Certificate.
10.1 (1)	Agreement and Plan of Merger between iParty Corp. and WSI Acquisitions Corp.
10.2 (1)	1998 Incentive and Non-Qualified Stock Option Plan.
10.3 (11)	Amended and Restated 1998 Incentive and Non-Qualified Stock Option Plan.
10.4 (14) ##	Employment Agreement between iParty Corp. and Sal Perisano, dated May 14, 2004.
10.5 (14) ##	Employment Agreement between iParty Corp. and Patrick Farrell, dated May 14, 2004.
10.6 (14) ##	Employment Agreement between iParty Corp. and Dorice Dionne, dated May 14, 2004.
10.7 (3)	Fulfillment Agreement between iParty Corp. and Taymark.
10.8 (11)	Extension to Fulfillment Agreement between iParty Corp. and Taymark.
10.9 (12)	Web Site License Agreement between iParty Corp. and Taymark, Inc.
10.10 (8)	Rights Agreement between iParty Corp. and Continental Stock Transfer & Trust, as Rights Agent.
10.11 (11)	Loan and Security Agreement between iParty Retail Stores Corp. and Paragon Capital LLC.
10.12 (10)	First Amendment to Loan and Security Agreement by and among iParty Corp., iParty Retail Stores Corp. and Wells Fargo Retail Finance, LLC.
10.13 (13)	Second Amendment to Loan and Security Agreement by and among iParty Corp., iParty Retail Stores Corp. and Wells Fargo Retail Finance II, LLC.
10.14 (11)	Trademark Security Agreement between iParty Retail Stores Corp. and Paragon Capital LLC.
10.15 (11)	Trademark Security Agreement between iParty Corp. and Wells Fargo Retail Finance, LLC.
10.16 (6)	Stock Purchase Agreement by and among iParty Corp., Ajmal Khan and Robert Lessin.
10.17 (7)	Stock Purchase Agreement between iParty Corp. and Patriot Capital Ltd.
10.18 (3)	Funding Agreement among iParty Corp., Robert Lessin and Ajmal Khan.
21.1 (15)	Subsidiaries of Registrant.
23.1 (15)	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
31.1 **	Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act.
31.2 **	Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act.
32.1 **	Certification of Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act.
32.2 **	Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act.

---

\*\* Filed herewith.

## Management contract or compensatory plan or arrangement.

(1) Filed as an exhibit to iParty's Registration Statement on Form 10-SB, Registration No. 0-25507, as filed with the SEC on March 8, 1999 and incorporated herein by reference.

(2) Filed as an exhibit to Amendment No. 2 to iParty's Registration Statement on Form 10-SB, Registration No. 0-25507, as filed with the SEC on October 19, 1999 and incorporated herein by reference.

(3) Filed as an exhibit to Amendment No. 1 to iParty's Registration Statement on Form 10-SB, Registration No. 0-25507, as filed with the SEC on July 12, 1999 and incorporated herein by reference.





## Edgar Filing: IPARTY CORP - Form 10-K/A

- (4) Filed as an exhibit to iParty's Annual Report on Form 10-KSB for the year ended December 31, 1999, as filed with the SEC on April 14, 2000 and incorporated herein by reference.
  - (5) Filed as an exhibit to iParty's Registration Statement on Form SB-2, Registration No. 333-40568, as filed with the SEC on June 30, 2000 and incorporated herein by reference.
  - (6) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on August 30, 2000 and incorporated herein by reference.
  - (7) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on September 15, 2000 and incorporated herein by reference.
  - (8) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on November 16, 2001 and incorporated herein by reference.
  - (9) Included as an exhibit (Exhibit C) to Exhibit 99.2 to iParty's Current Report on Form 8-K, filed with the SEC on November 16, 2001 and incorporated herein by reference.
  - (10) Filed as an exhibit to iParty's Quarterly Report on Form 10-QSB for the quarterly period ended June 29, 2002, as filed with the SEC on August 13, 2002 and incorporated herein by reference.
  - (11) Filed as an exhibit to iParty's Annual Report on Form 10-KSB for the year ended December 28, 2002, filed with the SEC on March 28, 2003 and incorporated herein by reference.
  - (12) Filed as an exhibit to iParty's Quarterly Report on Form 10-Q, filed with the SEC on August 12, 2003 and incorporated herein by reference.
  - (13) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on January 29, 2004 and incorporated herein by reference.
  - (14) Filed as an exhibit to iParty's Quarterly Report on Form 10-Q, filed with the SEC on August 10, 2004 and incorporated herein by reference.
  - (15) Filed as an exhibit to iParty's Annual Report on Form 10-K, filed with the SEC on March 25, 2005 and incorporated herein by reference.
-