

LIQUIDITY SERVICES INC
Form 10-Q
February 04, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2010

OR

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

For the transition period from _____ to _____

Commission file number 0-51813

LIQUIDITY SERVICES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of
Incorporation or Organization)

52-2209244

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

1920 L Street, N.W., 6th Floor, Washington, D.C.
(Address of Principal Executive Offices)

20036
(Zip Code)

(202) 467-6868

(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, If Changed Since Last Report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

The number of shares outstanding of the issuer's common stock, par value \$.001 per share, as of February 4, 2011 was 27,159,746.

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements.****Liquidity Services, Inc. and Subsidiaries
Consolidated Balance Sheets****(Dollars in Thousands)**

| | December 31, 2010 (Unaudited) | September 30, 2010 |
|---|--|-------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 48,525 | \$ 43,378 |
| Short-term investments | 32,947 | 33,405 |
| Accounts receivable, net of allowance for doubtful accounts of \$359 and \$328 at December 31, 2010 and September 30, 2010, respectively | 4,762 | 4,475 |
| Inventory | 18,687 | 17,321 |
| Prepaid expenses, deferred taxes and other current assets | 10,987 | 10,122 |
| Total current assets | 115,908 | 108,701 |
| Property and equipment, net | 7,822 | 6,781 |
| Intangible assets, net | 2,633 | 3,057 |
| Goodwill | 39,537 | 39,831 |
| Other assets | 6,532 | 6,534 |
| Total assets | \$ 172,432 | \$ 164,904 |
| Liabilities and stockholders equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 8,767 | \$ 8,605 |
| Accrued expenses and other current liabilities | 19,707 | 24,654 |
| Profit-sharing distributions payable | 6,372 | 5,596 |
| Acquisition earn out payable | 7,500 | |
| Customer payables | 12,474 | 9,783 |
| Total current liabilities | 54,820 | 48,638 |
| Deferred taxes and other long-term liabilities | 2,015 | 3,892 |
| Total liabilities | 56,835 | 52,530 |
| Stockholders equity: | | |
| Common stock, \$0.001 par value; 120,000,000 shares authorized; 29,264,574 shares issued and 27,102,518 shares outstanding at December 31, 2010; 28,827,072 shares issued and 26,894,591 shares outstanding at September 30, 2010 | 27 | 27 |
| Additional paid-in capital | 91,393 | 85,517 |
| Treasury stock, at cost | (21,884) | (18,343) |
| Accumulated other comprehensive loss | (5,140) | (4,645) |
| Retained earnings | 51,201 | 49,818 |
| Total stockholders equity | 115,597 | 112,374 |
| Total liabilities and stockholders equity | \$ 172,432 | \$ 164,904 |

See accompanying notes to the unaudited consolidated financial statements.

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Liquidity Services, Inc. and Subsidiaries
Unaudited Consolidated Statements of Operations
(Dollars in Thousands, Except Per Share Data)

| | Three Months Ended December 31, | |
|---|--|-------------|
| | 2010 | 2009 |
| Revenue | \$ 78,511 | \$ 65,313 |
| Costs and expenses: | | |
| Cost of goods sold (excluding amortization) | 32,939 | 26,950 |
| Profit-sharing distributions | 10,621 | 8,991 |
| Technology and operations | 13,324 | 12,086 |
| Sales and marketing | 6,015 | 4,647 |
| General and administrative | 6,737 | 5,940 |
| Amortization of contract intangibles | 203 | 203 |
| Depreciation and amortization | 1,190 | 911 |
| Acquisition costs | 4,695 | |
| Total costs and expenses | 75,724 | 59,728 |
| Income from operations | 2,787 | 5,585 |
| Interest income and other (expense), net | (21) | (14) |
| Income before provision for income taxes | 2,766 | 5,571 |
| Provision for income taxes | (1,383) | (2,631) |
| Net income | \$ 1,383 | \$ 2,940 |
| Basic earnings per common share | \$ 0.05 | \$ 0.11 |
| Diluted earnings per common share | \$ 0.05 | \$ 0.11 |
| Basic weighted average shares outstanding | 27,207,288 | 27,539,308 |
| Diluted weighted average shares outstanding | 28,291,022 | 27,673,241 |

See accompanying notes to the unaudited consolidated financial statements.

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Liquidity Services, Inc. and Subsidiaries
Unaudited Consolidated Statement of Changes in Stockholders' Equity

(In Thousands Except Share Data)

| | Treasury Stock | | Common Stock | | Additional | Accumulated | Retained | Total |
|---|----------------|-------------|--------------|--------|--------------------|--------------------------------|-----------|------------|
| | Shares | Amount | Shares | Amount | Paid-in Capital | Other Comprehensive Loss | Earnings | |
| Balance at September 30, 2010 | (1,932,481) | \$ (18,343) | 28,827,072 | \$ 27 | \$ 85,517 | \$ (4,645) | \$ 49,818 | \$ 112,374 |
| Common stock repurchased | (229,575) | (3,541) | | | | | | (3,541) |
| Exercise of common stock options and restricted stock | | | 437,502 | | 2,396 | | | 2,396 |
| Compensation expense from grants of common stock options and restricted stock | | | | | 3,480 | | | 3,480 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | | | | 1,383 | 1,383 |
| Foreign currency translation and other | | | | | | (495) | | (495) |
| Balance at December 31, 2010 | (2,162,056) | \$ (21,884) | 29,264,574 | \$ 27 | \$ 91,393 | \$ (5,140) | \$ 51,201 | \$ 115,597 |

See accompanying notes to the unaudited consolidated financial statements.

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Liquidity Services, Inc. and Subsidiaries
Unaudited Consolidated Statements of Cash Flows

(In Thousands)

| | Three Months Ended December 31, | |
|---|------------------------------------|-----------|
| | 2010 | 2009 |
| Operating activities | | |
| Net income | \$ 1,383 | \$ 2,940 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,393 | 1,114 |
| Stock compensation expense | 2,216 | 1,736 |
| Provision for inventory allowance | (167) | (10) |
| Provision for doubtful accounts | 31 | 40 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (316) | 399 |
| Inventory | (1,199) | (3,325) |
| Prepaid expenses and other assets | (865) | (815) |
| Accounts payable | 162 | 149 |
| Accrued expenses and other | 2,553 | 2,758 |
| Profit-sharing distributions payable | 776 | (145) |
| Customer payables | 2,691 | (1,078) |
| Other liabilities | (1,877) | (65) |
| Net cash provided by operating activities | 6,781 | 3,698 |
| Investing activities | | |
| Purchases of short-term investments | (6,131) | (18,147) |
| Proceeds from the sale of short-term investments | 6,575 | 10,583 |
| Increase in goodwill and intangibles | (21) | (59) |
| Purchases of property and equipment | (2,002) | (1,227) |
| Net cash used in investing activities | (1,579) | (8,850) |
| Financing activities | | |
| Principal repayments of capital lease obligations and debt | | (14) |
| Repurchases of common stock | (3,541) | (5,085) |
| Proceeds from exercise of common stock options (net of tax) | 2,396 | 76 |
| Incremental tax benefit from exercise of common stock options | 1,264 | |
| Net cash provided by (used in) financing activities | 119 | (5,023) |
| Effect of exchange rate differences on cash and cash equivalents | (174) | (223) |
| Net increase (decrease) in cash and cash equivalents | 5,147 | (10,398) |
| Cash and cash equivalents at beginning of period | 43,378 | 33,538 |
| Cash and cash equivalents at end of period | \$ 48,525 | \$ 23,140 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for income taxes | \$ 567 | \$ 463 |
| Cash paid for interest | 10 | 4 |
| Assets acquired under capital leases | | |
| Contingent purchase price accrued | 4,695 | |

See accompanying notes to the unaudited consolidated financial statements.

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Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements

1. Organization

Liquidity Services, Inc. and subsidiaries (LSI or the Company) is a leading online auction marketplace for surplus and salvage assets. LSI enables buyers and sellers to transact in an efficient, automated online auction environment offering over 500 product categories. The Company's marketplaces provide professional buyers access to a global, organized supply of surplus and salvage assets presented with digital images and other relevant product information. Additionally, LSI enables its corporate and government sellers to enhance their financial return on excess assets by providing a liquid marketplace and value-added services that integrate sales and marketing, logistics and transaction settlement into a single offering. LSI organizes its products into categories across major industry verticals such as consumer electronics, general merchandise, apparel, scientific equipment, aerospace parts and equipment, technology hardware, energy equipment, industrial capital assets and specialty equipment. The Company's online auction marketplaces are www.liquidation.com, www.govliquidation.com, www.govdeals.com, www.networkintl.com, www.secondipity.com, www.uk-liquidation.co.uk and www.liquibiz.com. LSI has one reportable segment consisting of operating online auction marketplaces for sellers and buyers of surplus, salvage and scrap assets.

2. Summary of Significant Accounting Policies

Unaudited Interim Financial Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles (GAAP) for complete financial statements. In the opinion of management, all adjustments, consisting of normal, recurring adjustments, considered necessary for a fair presentation have been included. The information disclosed in the notes to the consolidated financial statements for these periods is unaudited. Operating results for the three months ended December 31, 2010 are not necessarily indicative of the results that may be expected for the year ending September 30, 2011 or any future period.

The Company has evaluated subsequent events through the date that these financial statements were issued and filed with the Securities and Exchange Commission.

Short-Term Investments

Available-for-sale securities, which approximate par value, are stated at fair value, with the unrealized gains and losses reported in accumulated other comprehensive income. For the three months ended December 31, 2010 and 2009, the amount of unrealized losses reported in accumulated other comprehensive loss was approximately \$14,000 and \$42,000, respectively. Realized gains and losses and declines in fair value that are determined to be other-than-temporary on available-for-sale securities are included in interest income and other income, net. The cost of

securities sold is based on the specific identification method and the securities have a duration of three to twelve months. Interest and dividends on securities classified as available-for-sale are included in interest income and other income, net. Realized losses for sales of investments for the three months ended December 31, 2010 and 2009 were \$101,000 and \$3,000, respectively.

Stock-Based Compensation

The Company recognizes compensation cost for all share-based payments based on the grant-date fair value. As a result, the Company's income before provision for income taxes and net income for the three months ended December 31, 2010 and 2009 was approximately \$2,216,000 and \$1,108,000; and \$1,736,000 and \$937,000 lower, respectively, than if it had continued to account for share-based compensation under the previous authoritative guidance. The total compensation cost related to nonvested awards not yet recognized at December 31, 2010 was approximately \$24,073,000, which will be recognized over the weighted average vesting period of 26 months. The Company utilizes the Black-Scholes option pricing model to determine its share-based compensation expense. Inputs into the Black-Scholes model include volatility rates that range from 40% to 72%, a dividend rate of 0%, and risk-free interest rates that range from 0.31% to 5.05% since October 1, 2005. The Company anticipates a forfeiture rate of 18.4% based on its historical forfeiture rate. As a result of adopting the new authoritative guidance on October 1, 2005, the Company's basic and diluted earnings per share for the three months ended December 31, 2010 and 2009 were approximately \$0.04 and \$0.04; and \$0.03 and \$0.03 lower, respectively, than if it had continued to account for share-based compensation under the previous authoritative guidance.

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Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

Comprehensive Income

Comprehensive loss includes net income adjusted for foreign currency translation and unrealized gains and losses on available-for-sale securities, and is reflected as a separate component of stockholders' equity. For the three months ended December 31, 2010 and 2009 comprehensive income was approximately \$888,000 and \$2,825,000, respectively.

Earnings per Share

Basic net income attributable to common stockholders per share is computed by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding for the period. Diluted net income attributable to common stockholders per share includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The Company had 1,416,886 unvested restricted shares outstanding at December 31, 2010, which were issued at prices ranging from \$7.48 to \$15.47 during the years ended September 30, 2010 and 2009 and the three months ended December 31, 2010, of which only 746,459 and 133,933 shares have been included in the calculation of diluted income per share for the three months ended December 31, 2010 and 2009, respectively, due to the difference between the issuance price and the average market price for the period in which they have been outstanding. The Company has also excluded the following stock options in its calculation of diluted income per share because the option exercise prices were greater than the average market prices for the applicable period:

- (a) for the three months ended December 31, 2010, 264,552 options; and
- (b) for the three months ended December 31, 2009, 3,336,188 options;

The following summarizes the potential outstanding common stock of the Company as of the dates set forth below:

| | 2010 | December 31, (unaudited) 2009 |
|---|---|-------------------------------------|
| | (dollars in thousands except per share amounts) | |
| Weighted average shares calculation: | | |
| Basic weighted average shares outstanding | 27,207,288 | 27,539,308 |
| Treasury stock effect of options and restricted stock | 1,083,734 | 133,933 |

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| | | | | |
|--|----|------------|----|------------|
| Diluted weighted average common shares outstanding | | 28,291,022 | | 27,673,241 |
| Net income | \$ | 1,383 | \$ | 2,940 |
| Net income per common share: | | | | |
| Basic income per common share | \$ | 0.05 | \$ | 0.11 |
| Diluted income per common share | \$ | 0.05 | \$ | 0.11 |

3. Defense Logistics Agency (DLA) Disposition Services Contracts

The Company's original Surplus Contract with the Defense Logistics Agency (DLA) Disposition Services expired on December 17, 2008. Under the terms of the original Surplus Contract, the Company distributed to the DLA Disposition Services a fixed percentage of the profits realized from the ultimate sale of the inventory, after deduction for allowable expenses, as provided for under the terms of the original Surplus Contract. Profit-sharing distributions to the DLA Disposition Services for the three months ended December 31, 2010 and 2009 were \$0 and \$371,000, respectively, including accrued amounts, as of December 31, 2010 and 2009, of \$169,000 and \$360,000, respectively.

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Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

The Company responded to a RFP and was awarded the new Surplus Contract. Significant operations began under the new Surplus Contract during February 2009. The new Contract has a base term expiring in February 2012 with two one year renewal options. Under the new Surplus Contract, the Company is required to purchase all usable surplus property offered to the Company by the Department of Defense (DOD) at a fixed percentage equal to 1.8% of the DoD's original acquisition value. The Company retains 100% of the profits from the resale of the property and bears all of the costs for the merchandising and sale of the property. The new Surplus Contract contains a provision providing for a mutual termination of the contract for convenience.

As a result of the Surplus Contract, the Company is the sole remarketer of all DoD surplus turned into DLA Disposition Services available for sale within the United States, Puerto Rico, and Guam.

The Company has a Scrap Contract with DLA Disposition Services, in which the base term expires in June 2012 with three one year renewal options. Under the terms of the Scrap Contract, the Company is required to purchase all scrap government property referred to it by DLA Disposition Services. The Company distributes to DLA Disposition Services a fixed percentage of the profits realized from the ultimate sale of the inventory, after deduction for allowable expenses, as provided for under the terms of the Contract. Effective June 1, 2007, the profit-sharing distribution for the Scrap Contract was decreased from 80% to 77% in exchange for the Company's agreement to implement additional inventory assurance processes and procedures with respect to the mutilation of demilitarized scrap property sold by the Company. The Scrap Contract also has a performance incentive that allows the Company to receive up to an additional 2% of the profit sharing distribution. This incentive is measured annually on June 30th, and is applied to the prior 12 months. For the three months ended December 31, 2010 and 2009, profit-sharing distributions to the DLA Disposition Services under the Scrap Contract were \$10,326,000 and \$8,232,000, respectively, including accrued amounts, as of December 31, 2010 and 2009, of \$6,125,000 and \$3,973,000, respectively. The Scrap Contract may be terminated by either the Company or DLA Disposition Services if the rate of return performance ratio does not exceed specified benchmark ratios for two consecutive quarterly periods and the preceding twelve months. The Company has performed in excess of the benchmark ratios throughout the contract period through December 31, 2010.

As a result of the Scrap Contract, the Company is the sole remarketer of all U.S. Department of Defense scrap turned into DLA Disposition Services available for sale within the United States, Puerto Rico, and Guam.

4. Network International Acquisition Acquisition Costs

On June 15, 2010, the Company acquired the stock of Network International, Inc. for approximately \$10,305,000. The acquisition price included an upfront cash payment of \$7,500,000 and an earn-out payment. Under the terms of the agreement, the earn-out is based on EBITDA earned by Network International, Inc. during each of the three six month periods after the closing date of the acquisition through December 31, 2011. The Company estimated the fair value of the earn-out at the time of the acquisition to be \$2,805,000 out of a possible total earn out payment of \$7,500,000. Upon review of the estimate as of December 31, 2010, the Company has determined that the operating results of Network International are exceeding original estimates significantly, and has estimated that the full \$7,500,000 earn out payment is likely based on the last six months of operating history and estimates for the next 12 months. Therefore, the Company has recorded an additional liability of \$4,695,000 as of December 31, 2010 and reflected this increase in its statement of operations for the three months ended December 31, 2010 in accordance with new authoritative guidance related to business combinations issued by the FASB in December 2007, which the Company

adopted for fiscal year 2010.

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Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

5. Goodwill and Intangible Assets

The carrying amount of goodwill, as of December 31, 2010, is net of a \$3,405,000 decrease due to foreign currency translation.

Intangible assets at December 31, 2010 consisted of the following:

| | | | | | | | |
|------------------------------|-------|----|-------|----|---------|----|-------|
| | | | | | | | |
| Contract intangible | 7 | \$ | 5,694 | \$ | (4,406) | \$ | 1,288 |
| Covenants not to compete | 3 - 5 | | 2,985 | | (2,034) | | 951 |
| Total intangible assets, net | | | | | | \$ | 2,633 |

Future expected amortization of intangible assets at December 31, 2010 was as follows:

| Years ending September 30, | (in thousands) |
|------------------------------|----------------|
| 2011 (remaining nine months) | \$ 1,157 |
| 2012 | 1,213 |
| 2013 | 187 |
| 2014 | 15 |
| 2015 and after | 61 |
| Total | \$ 2,633 |

6. Debt

Senior Credit Facility

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In December 2002, and as subsequently amended, the Company entered into a senior credit facility with a bank, which provided for borrowings up to \$30.0 million. This senior credit facility expired on April 30, 2010. The Company had no outstanding borrowings under this facility as of April 30, 2010.

On April 30, 2010, the Company entered into a new senior credit facility (the Agreement) with a bank, which provides for borrowings up to \$30.0 million. Borrowings under the Agreement bear interest at an annual rate equal to the 30 day LIBOR rate plus 1.25% (1.512% at December 31, 2010) due monthly. As of September 30, 2010 and December 31, 2010, the Company had no outstanding borrowings under the Agreement.

Borrowings under the Agreement are secured by substantially all of the assets of the Company. The Agreement contains certain financial and non-financial restrictive covenants including, among others, the requirements to maintain a minimum level of earnings before interest, income taxes, depreciation and amortization (EBITDA) and a minimum debt coverage ratio. As of December 31, 2010, the Company was in compliance with these covenants.

7. Income Taxes

The Company's interim effective income tax rate is based on management's best current estimate of the expected annual effective income tax rate. The Company estimates that its fiscal year 2011 tax rate will be approximately 50%, which is an increase from the estimated 46% disclosed in the Company's fiscal year 2010 Form 10-K. The estimated 4% increase is a result of the estimated additional earn out payment described in Note 4, which is not deductible against U.S. taxable income. We estimate that our future effective income tax rate will be approximately 46%, which is comprised of (1) approximately 35% for federal taxes, (2) approximately 8% for state taxes, and (3) approximately 3% for book and tax differences including stock based compensation expenses, primarily related to employee stock options, which are currently expensed in our financial statements but are not deductible for tax purposes until they are exercised.

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Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

The Company applies the guidance related to uncertainty in income taxes. The Company has concluded that there were no uncertain tax positions identified during its analysis. The Company's policy is to recognize interest and penalties in the period in which they occur in the income tax provision. The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, various state and local jurisdictions and in foreign jurisdictions, primarily the U.K. Currently, the Company is not subject to any income tax examinations. The statute of limitations for years prior to fiscal 2007 is now closed. However, certain tax attribute carryforwards that were generated prior to fiscal 2007 may be adjusted upon examination by tax authorities if they are utilized.

8. Stockholders' Equity

Common Stock

On February 23, 2006, the Company issued 5,000,000 shares of common stock for net proceeds of \$43,977,000 in conjunction with its initial public offering. On March 13, 2007, the Company issued 100,000 shares of common stock for net proceeds of \$1,070,000 in conjunction with its follow-on offering.

Share Repurchase Program

On December 2, 2008, the Company's Board of Directors approved a \$10.0 million share repurchase program. Under the program, the Company is authorized to repurchase the issued and outstanding shares of common stock. Share repurchases may be made through open market purchases, privately negotiated transactions or otherwise, at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements and other market conditions. The repurchase program may be discontinued or suspended at any time, and will be funded using our available cash. On February 2, 2010, the Company's Board of Directors approved an additional \$10.0 million for the share repurchase program. On November 30, 2010, the Company's Board of Directors approved an additional \$10.0 million for the share repurchase program. The Company's Board of Directors reviews the share repurchase program periodically, the last such review having occurred in November 2010. During the year ended September 30, 2009, 707,462 shares were purchased under the program for approximately \$3,874,000. During the year ended September 30, 2010, 1,225,019 shares were purchased under the program for approximately \$14,471,000. During the three months ended December 31, 2010, 229,575 shares were purchased under the program for approximately \$3,541,000. As of December 31, 2010, approximately \$8,114,000 may yet be expended under the program.

2006 Omnibus Long-Term Incentive Plan (the 2006 Plan)

Under the 2006 Plan, 5,000,000 shares of common stock were initially reserved for issuance. In February 2009, at the Company's annual meeting of stockholders, the stockholders approved an increase of 5,000,000 shares of the Company's common stock to the shares available for issuance

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under the 2006 Plan. At September 30, 2009, there were 5,189,996 shares remaining reserved for issuance in connection with awards under the 2006 Plan. During fiscal year 2010, the Company granted options to purchase 624,566 shares to employees and directors with exercise prices between \$9.05 and \$13.96, and options to purchase 75,467 shares were forfeited. During fiscal year 2010, the Company granted 699,410 restricted shares to employees and directors at prices ranging from \$9.05 to \$13.96, and 45,026 restricted shares were forfeited. At September 30, 2010, there were 3,986,513 shares remaining reserved for issuance in connection with awards under the 2006 Plan. During the three months ended December 31, 2010, the Company issued options to purchase 231,000 shares to employees and directors with exercise prices between \$13.48 and \$17.02, and options to purchase 9,345 shares were forfeited. During the three months ended December 31, 2010, the Company issued 635,092 restricted shares to employees and directors at prices ranging from \$15.12 to \$15.47, and 15,313 restricted shares were forfeited. At December 31, 2010, there were 3,145,079 shares remaining reserved for issuance in connection with awards under the 2006 Plan. The maximum number of shares subject to options or stock appreciation rights that can be awarded under the 2006 Plan to any person is 1,000,000 per year. The maximum number of shares that can be awarded under the 2006 Plan to any person, other than pursuant to an option or stock appreciation right, is 700,000 per year.

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Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

Stock Option Activity

A summary of the Company's stock option activity for the year ended September 30, 2010 and the three months ended December 31, 2010 is as follows:

| | Options | Weighted- Average Exercise Price |
|---|-----------|--|
| Options outstanding at September 30, 2009 | 4,609,226 | \$ 10.95 |
| Options granted | 624,566 | 10.92 |
| Options exercised | (411,036) | 7.88 |
| Options canceled | (75,467) | 12.24 |
| Options outstanding at September 30, 2010 | 4,747,289 | 11.20 |
| Options granted | 231,000 | 15.56 |
| Options exercised | (261,442) | 9.17 |
| Options canceled | (9,345) | 11.80 |
| Options outstanding at December 31, 2010 | 4,707,502 | 11.52 |
| Options exercisable at December 31, 2010 | 2,621,266 | 12.00 |

The intrinsic value of outstanding and exercisable options at December 31, 2010 is approximately \$13,100,000 and \$6,206,000, respectively, based on a stock price of \$14.05 on December 31, 2010.

Restricted Share Activity

A summary of the Company's restricted share activity for the year ended September 30, 2010 and the three months ended December 31, 2010 is as follows:

| | Restricted Shares | Weighted- Average Fair Value |
|--|----------------------|------------------------------------|
| Unvested restricted shares at September 30, 2009 | 462,836 | \$ 8.88 |
| Restricted shares granted | 699,410 | 10.00 |
| Restricted shares vested | (144,053) | 8.47 |
| Restricted shares canceled | (45,026) | 9.30 |
| Unvested restricted shares at September 30, 2010 | 973,167 | 9.73 |
| Restricted shares granted | 635,092 | 15.44 |
| Restricted shares vested | (176,060) | 8.79 |
| Restricted shares canceled | (15,313) | 10.17 |

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| | | |
|---|-----------|-------|
| Unvested restricted shares at December 31, 2010 | 1,416,886 | 12.40 |
|---|-----------|-------|

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Liquidity Services, Inc. and Subsidiaries
Notes to the Unaudited Consolidated Financial Statements (Continued)

9. Fair Value Measurement

The Company measures and records in the accompanying condensed consolidated financial statements certain assets and liabilities at fair value on a recurring basis. Authoritative guidance issued by the FASB establishes a fair value hierarchy for those instruments measured at fair value that distinguishes between assumptions based on market data (observable inputs) and the Company's assumptions (unobservable inputs). The hierarchy consists of three levels:

- Level 1 Quoted market prices in active markets for identical assets or liabilities;
- Level 2 Inputs other than Level 1 inputs that are either directly or indirectly observable; and
- Level 3 Unobservable inputs developed using estimates and assumptions developed by the Company, which reflect those that a market participant would use.

As of December 31, 2010 and September 30, 2010, the Company's Level 1 short-term investments of \$32,947,000 and \$33,405,000, respectively, are the only financial assets measured at fair value. As of December 31, 2010 and September 30, 2010, the Company's \$7,500,000 and \$2,805,000 liability for the earn-out related to the Network International acquisition is the only liability measured at fair value on a recurring basis and is classified as Level 3 within the fair value hierarchy. The changes in liabilities measured at fair value for which the Company has used Level 3 inputs to determine fair value for the year ended September 30, 2010 and the three months ended December 31, 2010 are as follows (\$ in thousands):

| | Level 3 Liabilities |
|--------------------------------------|--------------------------------|
| Balance at September 30, 2009 | |
| Acquisition contingent consideration | \$ 2,805 |
| Purchases and issuances | |
| Sales and settlements | |
| Unrealized gains (losses), net | |
| Balance at September 30, 2010 | 2,805 |
| Acquisition contingent consideration | 4,695 |
| Purchases and issuances | |
| Sales and settlements | |
| Unrealized gains (losses), net | |
| Balance at December 31, 2010 | \$ 7,500 |

The Company did not have any Level 3 assets or liabilities prior to fiscal year 2010.

When valuing its Level 3 liability, the Company gives consideration to operating results, financial condition, economic and/or market events, and other pertinent information that would impact its estimate of the expected earn-out payment. The valuation procedures are primarily based on management's projection of EBITDA for Network International and applying a discount to the expected proceeds to estimate fair value. Because of the inherent uncertainty, this estimated value may differ significantly from the value that would have been used had a ready market

for the liability existed, and it is reasonably possible that the difference could be material.

10. Contingencies

In January 2008, Kormendi/Gardener Partners (KGP) commenced litigation against Government Liquidation.com (GL) and Surplus Acquisition Venture, LLC (SAV), two of the Company's subsidiaries, seeking \$1.5 million in damages. KGP claims it is entitled to these damages because of actions GL and SAV took at the direction of DLA Disposition Services pursuant to an amendment to the original Surplus Contract entered into in August 2006. GL and SAV believe they have meritorious defenses in this litigation. In addition, SAV and GL believe they likely would be able to recover their costs and damages arising out of this litigation from DLA Disposition Services under the terms of the original Surplus Contract.

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

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements. These statements are only predictions. The outcome of the events described in these forward-looking statements is subject to known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. These risks and other factors include but are not limited to the factors set forth in our Annual Report on Form 10-K for the year ended September 30, 2010 and subsequent filings with the Securities and Exchange Commission. You can identify forward-looking statements by terminology such as may, will, should, could, would, expects, intends, plans, anticipates, believes, estimates, predicts, potential, continues or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. There may be other factors of which we are currently unaware or deem immaterial that may cause our actual results to differ materially from the forward-looking statements.

All forward-looking statements attributable to us or persons acting on our behalf apply only as of the date of this document and are expressly qualified in their entirety by the cautionary statements included in this document. Except as may be required by law, we undertake no obligation to publicly update or revise any forward-looking statement to reflect events or circumstances occurring after the date of this document or to reflect the occurrence of unanticipated events.

The following discussion should be read in conjunction with our consolidated financial statements and related notes and the information contained elsewhere in this document.

Overview

About us. We are a leading online auction marketplace for surplus and salvage assets. We enable buyers and sellers to transact in an efficient, online auction environment offering over 500 product categories. Our marketplaces provide professional buyers access to a global, organized supply of surplus and salvage assets presented with customer focused information including digital images and other relevant product information along with services to efficiently complete the transaction. Additionally, we enable our corporate and government sellers to enhance their financial return on excess assets by providing liquid marketplaces and value-added services that integrate sales and marketing, logistics and transaction settlement into a single offering. We organize our products into categories across major industry verticals such as consumer electronics, general merchandise, apparel, scientific equipment, aerospace parts and equipment, technology hardware, energy equipment, industrial capital assets and specialty equipment. Our online auction marketplaces are www.liquidation.com, www.govliquidation.com, www.govdeals.com, www.networkintl.com, www.secondipity.com, www.uk-liquidation.co.uk and www.liquibiz.com. We also operate a wholesale industry portal, www.goWholesale.com that connects advertisers with buyers seeking products for resale and related business services.

We believe our ability to create liquid marketplaces for surplus and salvage assets generates a continuous flow of goods from our corporate and government sellers. This flow of goods in turn attracts an increasing number of professional buyers to our marketplaces. During the last 12 months, the number of registered buyers grew from approximately 1,255,000 to approximately 1,461,000, or 16.4%.

Recent initiatives. With the addition of Network International, we have accelerated our growth in the capital assets market, which is a growing area of interest and opportunity. Network International has strengthened the scale and reach of our capital assets business by adding 22 Fortune 500 corporations and eight of the world's largest multinationals across the energy supply chain as new clients. The sale of capital assets currently comprises approximately 50% of our GMV, and clients with idle and used capital equipment are increasing their financial recovery and improving cycle times by accessing our menu of value added services and base of over 400,000 registered buyers of capital assets, ranging from heavy machinery to rolling stock and scrap metal.

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As a result, we have increased our estimate of the fair value of the earn-out at the time of the Network International acquisition from \$2,805,000, out of a possible total earn out payment of \$7,500,000, to \$7,500,000. Upon review of the estimate as of December 31, 2010, we determined that the operating results of Network International are exceeding original estimates significantly, and have estimated that the full \$7,500,000 earn out payment is likely based on the last six months of operating history and estimates for the next 12 months. Therefore, we recorded an additional liability of \$4,695,000 as of December 31, 2010 and reflected this increase in the statement of operations for the three months ended December 31, 2010 in accordance with new authoritative guidance related to business combinations issued by the FASB in December 2007, which we adopted for fiscal year 2010.

Our revenue. We generate substantially all of our revenue by retaining a percentage of the proceeds from the sales we manage for our sellers. We offer our sellers three primary transaction models: a profit-sharing model, a consignment model and a purchase model.

- *Profit-sharing model.* Under our profit-sharing model, we purchase inventory from our suppliers and share with them a portion of the profits received from a completed sale in the form of a distribution. Distributions are calculated based on the value received from the sale after deducting direct costs, such as sales and marketing, technology and operations and other general and administrative costs. Because we are the primary obligor, and take general and physical inventory risks and credit risk under this transaction model, we recognize as revenue the sale price paid by the buyer upon completion of a transaction. Revenue from our profit-sharing model accounted for approximately 22.7 % of our total revenue for the three months ended December 31, 2010. The merchandise sold under our profit-sharing model accounted for approximately 14.1% of our gross merchandise volume, or GMV, for the three months ended December 31, 2010.

- *Consignment model.* Under our consignment model, we recognize commission revenue from sales of merchandise in our marketplaces that is owned by others. These commissions, which we refer to as seller commissions, represent a percentage of the sale price the buyer pays upon completion of a transaction. We vary the percentage amount of the seller commission depending on the various value-added services we provide to the seller to facilitate the transaction. For example, we generally increase the percentage amount of the commission if we take possession, handle, ship or provide enhanced product information for the merchandise. We collect the seller commission by deducting the appropriate amount from the sales proceeds prior to their distribution to the seller after completion of the transaction. Revenue from our consignment model accounted for approximately 8.8% of our total revenue for the three months ended December 31, 2010. The merchandise sold under our consignment model accounted for approximately 43.5% of our GMV for the three months ended December 31, 2010.

- *Purchase model.* Under our purchase model, we offer our sellers a fixed amount or the option to share a portion of the proceeds received from our completed sales in the form of a distribution. Distributions are calculated based on the value we receive from the sale after deducting a required return to us that we have negotiated with the seller. Because we are the primary obligor, and take general and physical inventory risks and credit risk under this transaction model, we recognize as revenue the sale price paid by the buyer upon completion of a transaction. Revenue from our purchase model accounted for approximately 66.8% of our total revenue for the three months ended December 31, 2010. The merchandise sold under our purchase model accounted for approximately 41.4% of our GMV for the three months ended December 31, 2010.

We collect a buyer premium on substantially all of our transactions under all of our transaction models. Buyer premiums are calculated as a percentage of the sale price of the merchandise sold and are paid to us by the buyer. Buyer premiums are in addition to the price of the merchandise. Under our profit-sharing model, we typically share the proceeds of any buyer premiums with our sellers.

Industry trends. We believe there are several industry trends impacting the growth of our business including: (1) the increase in the adoption of the Internet by businesses to conduct e-commerce both in the United States and abroad; (2) product innovation in the retail supply chain that has

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increased the pace of product obsolescence and, therefore, the supply of surplus assets; (3) the increase in the volume of returned merchandise handled by both online and offline retailers; (4) the increase in government regulations necessitating verifiable recycling and remarketing of surplus assets; (5) the increase in outsourcing by corporate and government organizations of disposition activities for surplus and end-of-life assets; and (6) as a result of the economic downturn, an increase in buyer demand for surplus merchandise as consumers trade down by purchasing less expensive goods and seek greater value from their purchases, which results in lower per unit prices and margins in our retail goods business.

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Our Seller Agreements

Our DoD agreements. We have two contracts with the DoD pursuant to which we acquire, manage and sell excess property:

- *Surplus Contract.* In June 2001, we were awarded the original Surplus Contract, a competitive-bid exclusive contract under which we acquire, manage and sell all usable DoD surplus personal property turned into the DLA Disposition Services. Surplus property generally consists of items determined by the DoD to be no longer needed, and not claimed for reuse by, any federal agency, such as computers, electronics, office supplies, scientific and medical equipment, aircraft parts, clothing and textiles. On November 6, 2008, the DoD extended the original Surplus Contract through December 17, 2008, thus we received 39.5% of the net proceeds on property received up until December 17, 2008 through the Contract wind down period, which was completed during fiscal year 2010. We responded to a RFP from the DLA Disposition Services regarding a renewal of the Surplus Contract, and we were awarded the contract. We began operations under the new Surplus Contract on December 18, 2008. The new Surplus Contract expires in February 2012, subject to the DoD's right to extend it for two additional one-year terms. Revenue from our Surplus Contract (including buyer premiums) accounted for approximately 30.6% of our total revenue for the three months ended December 31, 2010. The property sold under our Surplus Contract accounted for approximately 19.0% of our GMV for the three months ended December 31, 2010.

- *Scrap Contract.* In June 2005, we were awarded a competitive-bid exclusive contract under which we acquire, manage and sell substantially all scrap property of the DoD turned into the DLA Disposition Services. Scrap property generally consists of items determined by the DoD to have no use beyond their base material content, such as metals, alloys, and building materials. We were required to pay \$5.7 million to the DoD in fiscal 2005 for the right to manage the operations and remarket scrap material in connection with the Scrap Contract. The Scrap Contract expires in June 2012, subject to the DoD's right to extend it for three additional one-year terms. Revenue from our Scrap Contract (including buyer premiums) accounted for approximately 22.7% of our total revenue for the three months ended December 31, 2010. The property sold under our Scrap Contract accounted for approximately 14.1% of our GMV for the three months ended December 31, 2010.

Under the original Surplus Contract, we were obligated to purchase all DoD surplus property at set prices representing a percentage of the original acquisition cost, which varied depending on the type of surplus property being purchased. Under the Scrap Contract, we acquire scrap property at a per pound price. We were initially entitled to approximately 20% of the profits of sale (defined as gross proceeds of sale less allowable operating expenses) under the Scrap Contract and the original Surplus Contract, and the DoD was entitled to approximately 80% of the profits. We refer to these disbursement payments to the DoD as profit-sharing distributions. As a result of these arrangements, we recognize as revenue the gross proceeds from these sales. The DoD also reimburses us for actual costs incurred for packing, loading and shipping property under the Scrap and original Surplus Contracts that we are obligated to pick up from non-DoD locations. On May 13, 2008, the DoD agreed to extend the original Surplus Contract through November 1, 2008, as well as increase our share of net proceeds under the original Surplus Contract to 39.5% on property received after June 18, 2008. On November 6, 2008, the DoD extended the original Surplus Contract through December 17, 2008. Under the new Surplus Contract, which began on December 18, 2008, we are not required to distribute any portion of the profits realized under the Contract, as the new Contract contains a higher fixed percentage price of 1.8%, of the DLA Disposition Services acquisition value, to be paid for the property.

Under the Scrap Contract, we also have a small business performance incentive based on the number of scrap buyers that are small businesses that allows us to receive up to an additional 2% of the profit sharing distribution. On May 21, 2007, we entered into a bilateral contract modification under which the DoD agreed to increase our profit-sharing distribution for the Scrap Contract from 20% to 23% effective June 1, 2007, in exchange for our agreement to implement additional inventory assurance processes and procedures with respect to the mutilation of demilitarized scrap property sold.

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Our commercial agreements. We have over 500 corporate clients each of which has sold in excess of \$10,000 of surplus and salvage assets in our marketplaces during the last twelve months. Our agreements with these clients are generally terminable at will by either party.

Key Business Metrics

Our management periodically reviews certain key business metrics for operational planning purposes and to evaluate the effectiveness of our operational strategies, allocation of resources and our capacity to fund capital expenditures and expand our business. These key business metrics include:

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Gross merchandise volume. Gross merchandise volume, or GMV, is the total sales value of all merchandise sold through our marketplaces during a given period. We review GMV because it provides a measure of the volume of goods being sold in our marketplaces and thus the activity of those marketplaces. GMV also provides a means to evaluate the effectiveness of investments that we have made and continue to make, including in the areas of customer support, value-added services, product development, sales and marketing, and operations. The GMV of goods sold in our marketplaces during the three months ended December 31, 2010 totaled \$126.8 million.

Completed transactions. Completed transactions represents the number of auctions in a given period from which we have recorded revenue. Similar to GMV, we believe that completed transactions is a key business metric because it provides an additional measurement of the volume of activity flowing through our marketplaces. During the three months ended December 31, 2010, we completed approximately 124,000 transactions.

Total registered buyers. We grow our buyer base through a combination of marketing and promotional efforts. A person becomes a registered buyer by completing an online registration process on one of our marketplaces. As part of this process, we collect business and personal information, including name, title, company name, business address and contact information, and information on how the person intends to use our marketplaces. Each prospective buyer must also accept our terms and conditions of use. Following the completion of the online registration process, we verify each prospective buyer's e-mail address and confirm that the person is not listed on any banned persons list maintained internally or by the U.S. federal government. After the verification process, which is completed generally within 24 hours, the registration is approved and activated and the prospective buyer is added to our registered buyer list.

Total registered buyers as of a given date represents the aggregate number of persons or entities who have registered on one of our marketplaces. We use this metric to evaluate how well our marketing and promotional efforts are performing. Total registered buyers excludes duplicate registrations, buyers who are suspended from utilizing our marketplaces and those buyers who have voluntarily removed themselves from our registration database. In addition, if we become aware of registered buyers that are no longer in business, we remove them from our database. As of December 31, 2010, we had approximately 1,461,000 registered buyers.

Total auction participants. For each auction we manage, the number of auction participants represents the total number of registered buyers who have bid one or more times in that auction. As a result, a registered buyer who bids, or participates, in more than one auction is counted as an auction participant in each auction in which he or she participates. Thus, total auction participants for a given period is the sum of the auction participants in each auction conducted during that period. We use this metric to allow us to compare our online auction marketplaces to our competitors, including other online auction sites and traditional on-site auctioneers. In addition, we measure total auction participants on a periodic basis to evaluate the activity level of our base of registered buyers and to measure the performance of our marketing and promotional efforts. For the three months ended December 31, 2010, approximately 500,000 total auction participants participated in auctions on our marketplaces.

Non-GAAP Financial Measures

EBITDA and adjusted EBITDA. EBITDA is a supplemental non-GAAP financial measure and is equal to net income plus interest income and other (expense), net; provision for income taxes; amortization of contract intangibles; and depreciation and amortization. Our definition of adjusted EBITDA differs from EBITDA because we further adjust EBITDA for stock-based compensation expense and acquisition costs.

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We believe EBITDA and adjusted EBITDA are useful to an investor in evaluating our performance for the following reasons:

- The amortization of contract intangibles relates to amortization of the Scrap Contract beginning in June 2005. Depreciation and amortization expense primarily relates to property and equipment. Both of these expenses are non-cash charges that have fluctuated significantly over the past five years. As a result, we believe that adding back these non-cash charges to net income is useful in evaluating the operating performance of our business on a consistent basis from year-to-year.
- As a result of varying federal and state income tax rates, we believe that presenting a financial measure that adjusts net income for provision for income taxes is useful to investors when evaluating the operating performance of our business.

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- In December 2004, the Financial Accounting Standards Board (FASB) issued new authoritative guidance that requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated fair values. Pro forma disclosure is no longer an alternative. We adopted the provisions of this new guidance on October 1, 2005, using the prospective method. Unvested stock based awards issued prior to October 1, 2005, the date that we adopted this new authoritative guidance, were accounted for at the date of adoption using the intrinsic value method originally applied to those awards. Accordingly, we believe adjusting net income for this non-cash stock based compensation expense is useful to investors when evaluating the operating performance of our business.

- In December 2007, the FASB issued new authoritative guidance related to business combinations. This guidance changes the accounting for acquisitions by eliminating the step acquisition model, changing the recognition of contingent consideration so that it is recognized at the time of acquisition rather than when it is probable, disallowing the capitalization of transaction costs and delaying when restructurings related to acquisitions can be recognized. We adopted this guidance for the fiscal year beginning October 1, 2009. Accordingly, we believe adjusting net income for these acquisition related expenses is useful to investors when evaluating the operating performance of our business on a consistent basis from year-to-year.

- We believe these measures are important indicators of our operational strength and the performance of our business because they provide a link between profitability and operating cash flow.

- We also believe that analysts and investors use EBITDA and adjusted EBITDA as supplemental measures to evaluate the overall operating performance of companies in our industry.

Our management uses EBITDA and adjusted EBITDA:

- as measurements of operating performance because they assist us in comparing our operating performance on a consistent basis as they remove the impact of items not directly resulting from our core operations;

- for planning purposes, including the preparation of our internal annual operating budget;

- to allocate resources to enhance the financial performance of our business;

- to evaluate the effectiveness of our operational strategies; and

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- to evaluate our capacity to fund capital expenditures and expand our business.

EBITDA and adjusted EBITDA as calculated by us are not necessarily comparable to similarly titled measures used by other companies. In addition, EBITDA and adjusted EBITDA: (a) do not represent net income or cash flows from operating activities as defined by GAAP; (b) are not necessarily indicative of cash available to fund our cash flow needs; and (c) should not be considered as alternatives to net income, income from operations, cash provided by operating activities or our other financial information as determined under GAAP.

We prepare adjusted EBITDA by adjusting EBITDA to eliminate the impact of items that we do not consider indicative of our core operating performance. You are encouraged to evaluate these adjustments and the reasons we consider them appropriate for supplemental analysis. As an analytical tool, adjusted EBITDA is subject to all of the limitations applicable to EBITDA. Our presentation of adjusted EBITDA should not be construed as an implication that our future results will be unaffected by unusual or non-recurring items.

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The table below reconciles net income to EBITDA and adjusted EBITDA for the periods presented.

| | Three Months Ended December 31, | |
|--|--|-----------------|
| | 2010 | 2009 |
| | (In thousands) (Unaudited) | |
| Net income | \$ 1,383 | \$ 2,940 |
| Interest income and other (expense), net | 21 | 14 |
| Provision for income taxes | 1,383 | 2,631 |
| Amortization of contract intangibles | 203 | 203 |
| Depreciation and amortization | 1,190 | 911 |
| EBITDA | 4,180 | 6,699 |
| Stock compensation expense | 2,216 | 1,736 |
| Acquisition costs | 4,695 | |
| Adjusted EBITDA | \$ 11,091 | \$ 8,435 |

Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. A critical accounting estimate is one which is both important to the portrayal of our financial condition and results and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. We continuously evaluate our critical accounting estimates. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue recognition. For transactions in our online marketplaces, which generate substantially all of our revenue, we recognize revenue when all of the following criteria are met:

- a buyer submits the winning bid in an auction and, as a result, evidence of an arrangement exists and the sale price has been determined;
- title has passed to a buyer and the buyer has assumed risks and rewards of ownership; and
- collection is reasonably assured.

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Substantially all of our sales are recorded subsequent to payment authorization being received, utilizing credit cards, wire transfers and PayPal, an Internet based payment system, as methods of payments. As a result, we are not subject to significant collection risk, as goods are generally not shipped before payment is received.

Revenue is also evaluated for reporting revenue of gross proceeds as the principal in the arrangement or net of commissions as an agent. In arrangements in which we are deemed to be the primary obligor, bear physical and general inventory risk, and credit risk, we recognize as revenue the gross proceeds from the sale, including buyer's premiums. Arrangements in which we act as an agent or broker on a consignment basis, without taking general or physical inventory risk, revenue is recognized based on the sales commissions that are paid to us by the sellers for utilizing our services; in this situation, sales commissions represent a percentage of the gross proceeds from the sale that the seller pays to us upon completion of the transaction.

We have evaluated our revenue recognition policy related to sales under our profit-sharing model and determined it is appropriate to account for these sales on a gross basis. The following factors were most heavily relied upon in our determination:

- We are the primary obligor in the arrangement.
- We are the seller in substance and in appearance to the buyer; the buyer contacts us if there is a problem with the purchase. Only we and the buyer are parties to the sales contract and the buyer has no recourse to the supplier. If the buyer has a problem, he or she looks to us, not the supplier.

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- The buyer does not and cannot look to the supplier for fulfillment or for product acceptability concerns.
- We have general inventory risk.
- We take title to the inventory upon paying the amount set forth in the contract with the supplier. Such amount is generally a percentage of the supplier's original acquisition cost and varies depending on the type of the inventory purchased or a fixed price per pound under our Scrap Contract.
- We are at risk of loss for all amounts paid to the supplier in the event the property is damaged or otherwise becomes unsaleable. In addition, as payments made for inventory are excluded from the calculation for the profit-sharing distribution under our DoD contracts, we effectively bear inventory risk for the full amount paid to acquire the property (*i.e.*, there is no sharing of inventory risk).

Valuation of goodwill and other intangible assets. We identify and value intangible assets that we acquire in business combinations, such as customer arrangements, customer relationships and non-compete agreements, that arise from contractual or other legal rights or that are capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged. The fair value of identified intangible assets is based upon an estimate of the future economic benefits expected to result from ownership, which represents the amount at which the assets could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

We test our goodwill and other intangible assets for impairment annually or more frequently if events or circumstances indicate impairment may exist. Examples of such events or circumstances could include a significant change in business climate or a loss of significant customers. We apply a two-step fair value-based test to assess goodwill for impairment. The first step compares the fair value of a reporting unit to its carrying amount, including goodwill. If the carrying amount of the reporting unit exceeds its fair value, the second step is then performed. The second step compares the carrying amount of the reporting unit's goodwill to the fair value of the goodwill. If the fair value of the goodwill is less than the carrying amount, an impairment loss would be recorded in our statements of operations. Intangible assets with definite lives are amortized over their estimated useful lives and are also reviewed for impairment if events or changes in circumstances indicate that their carrying amount may not be realizable.

Our management makes certain estimates and assumptions in order to determine the fair value of net assets and liabilities, including, among other things, an assessment of market conditions, projected cash flows, cost of capital and growth rates, which could significantly impact the reported value of goodwill and other intangible assets. Estimating future cash flows requires significant judgment, and our projections may vary from cash flows eventually realized. The valuations employ a combination of present value techniques to measure fair value, corroborated by comparisons to estimated market multiples. These valuations are based on a discount rate determined by our management to be consistent with industry discount rates and the risks inherent in our current business model.

We cannot predict the occurrence of certain future events that might adversely affect the reported value of goodwill and other intangible assets, which totaled \$42.2 million at December 31, 2010. Such events may include strategic decisions made in response to economic and competitive conditions, the impact of the economic environment on our base of buyers and sellers or material negative changes in our relationships with material customers.

Income taxes. We account for income taxes using the asset and liability approach for measuring deferred taxes based on temporary differences between the financial statement and income tax bases of assets and liabilities existing at each balance sheet date using enacted tax rates for the years in which the taxes are expected to be paid or recovered. A valuation allowance is provided to reduce the deferred tax assets to a level that we believe will more likely than not be realized. The resulting net deferred tax asset reflects management's estimate of the amount that will be realized.

We apply the guidance related to accounting for uncertainty in income taxes. We concluded that there were no uncertain tax positions identified during its analysis.

We provide for income taxes based on our estimate of federal and state tax liabilities. These estimates include, among other items, effective rates for state and local income taxes, estimates related to depreciation and amortization expense allowable for tax purposes, and the tax deductibility of certain other items. Our estimates are based on the information available to us at the time we prepare the income tax provision. We generally file our annual income tax returns several months after our fiscal year-end. Income tax returns are subject to audit by federal, state and local governments, generally years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws.

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Stock-based compensation. We recognize in the statements of operations all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated fair values. We use the Black-Scholes option pricing model to estimate the fair values of share-based payments.

The above list is not intended to be a comprehensive list of all of our accounting estimates. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP, with little need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our audited financial statements and related notes, which contain accounting policies and other disclosures required by GAAP.

Components of Revenue and Expenses

Revenue. We generate substantially all of our revenue from sales of merchandise held in inventory and by retaining a percentage of the proceeds from the sales. Our revenue recognition practices are discussed in more detail in the section above entitled *Critical Accounting Estimates*.

Cost of goods sold (excluding amortization). Cost of goods sold includes the costs of purchasing and transporting property for auction, as well as credit card transaction fees.

Profit-sharing distributions. Our Scrap and original Surplus Contracts with the DoD have been structured as profit-sharing arrangements in which we purchase and take possession of all goods we receive from the DoD at a contractual percentage of the original acquisition cost of those goods or at a per pound price for scrap. After deducting allowable operating expenses, we disburse to the DoD on a monthly basis a percentage of the profits of the aggregate monthly sales. We retain the remaining percentage of these profits after the DoD's disbursement. We refer to these disbursement payments to the DoD as profit-sharing distributions.

Technology and operations. Technology expenses consist primarily of personnel costs related to our programming staff who develop and deploy new marketplaces and continuously enhance existing marketplaces. These personnel also develop and upgrade the software systems that support our operations, such as sales processing. Because our marketplaces and support systems require frequent upgrades and enhancements to maintain viability, we have determined that the useful life for substantially all of our internally developed software is less than one year. As a result, we expense these costs as incurred.

Operations expenses consist primarily of operating costs, including buyer relations, shipping logistics and distribution center operating costs.

Sales and marketing. Sales and marketing expenses include the cost of our sales and marketing personnel as well as the cost of marketing and promotional activities. These activities include online marketing campaigns such as paid search advertising.

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General and administrative. General and administrative expenses include all corporate and administrative functions that support our operations and provide an infrastructure to facilitate our future growth. Components of these expenses include executive management and staff salaries, bonuses and related taxes and employee benefits; travel; headquarters rent and related occupancy costs; and legal and accounting fees. The salaries, bonus and employee benefits costs included as general and administrative expenses are generally more fixed in nature than our operating expenses and do not vary directly with the volume of merchandise sold through our marketplaces.

Amortization of contract intangibles. Amortization of contract intangibles expense consists of the amortization of our Scrap Contract award during June 2005. This contract required us to purchase the rights to operate the scrap operations of the DoD during the seven year base term of the contract. The intangible asset created from the \$5.7 million purchase is being amortized over 84 months on a straight-line basis. The amortization period is correlated to the base term of the contract, exclusive of renewal periods.

Depreciation and amortization. Depreciation and amortization expenses consist primarily of the depreciation and amortization of amounts recorded in connection with the purchase of furniture, fixtures and equipment.

Interest income and other (expense), net. Interest income and other income, net consists primarily of interest income on cash and short-term investments and interest expense on borrowings under our notes payable and realized gains or losses on short-term investments.

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Income taxes. During fiscal years 2008, 2009 and 2010, we had an effective income tax rate of approximately 43%, 58% and 50%, respectively, which included federal, state and foreign income taxes. Our 2009 effective income tax rate increased principally because we recorded a \$1,287,000 valuation allowance against the deferred tax assets of our foreign subsidiaries, consisting principally of net operating loss carryforwards. \$960,000 of the valuation allowance was necessitated by losses in recent years at our UK subsidiary, especially in 2009, primarily as a result of the loss of our largest client. Our 2010 effective income tax rate continued to be higher than expected as a result of continued losses in our UK subsidiary, which are not deductible against our US income. We estimate that our fiscal year 2011 tax rate will be approximately 50%, which is an increase from the estimated 46% disclosed in our fiscal year 2010 Form 10-K. The estimated 4% increase is a result of the estimated additional earn out payment described in Note 4 to the financial statements, which is not deductible against U.S. taxable income. We estimate that our future effective income tax rate will be approximately 46%, which is comprised of (1) approximately 35% for federal taxes, (2) approximately 8% for state taxes, and (3) approximately 3% for book and tax differences including stock based compensation expenses, primarily related to employee stock options, which are currently expensed in our financial statements but are not deductible for tax purposes until they are exercised

Results of Operations

The following table sets forth, for the periods indicated, selected statement of operations data expressed as a percentage of revenue.

| | Three Months Ended December 31, | |
|---|------------------------------------|--------|
| | 2010 | 2009 |
| Revenue | 100.0% | 100.0% |
| Costs and expenses: | | |
| Cost of goods sold (excluding amortization) | 42.0 | 41.3 |
| Profit-sharing distributions | 13.5 | 13.8 |
| Technology and operations | 16.9 | 18.5 |
| Sales and marketing | 7.7 | 7.1 |
| General and administrative | 8.6 | 9.1 |
| Amortization of contract intangibles | 0.3 | 0.4 |
| Depreciation and amortization | 1.4 | 1.3 |
| Acquisition costs | 6.0 | |
| Total costs and expenses | 96.4 | 91.5 |
| Income from operations | 3.6 | 8.5 |
| Interest income and other (expense), net | 0.0 | 0.0 |
| Income before provision for income taxes | 3.6 | 8.5 |
| Provision for income taxes | (1.8) | (4.0) |
| Net income | 1.8% | 4.5% |

Three Months Ended December 31, 2010 Compared to Three Months Ended December 31, 2009

Revenue. Revenue increased \$13.2 million, or 20.2%, to \$78.5 million for the three months ended December 31, 2010 from \$65.3 million for the three months ended December 31, 2009. This was primarily due to (1) a 22.9% increase, or \$3.3 million, in our scrap business, which utilizes the profit sharing model, as a result of increasing commodity prices and a higher mix of high value metals; (2) a 22.1% increase, or \$4.4 million,

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in our surplus business, as a result of increasing property flow from the DoD and a higher mix of high value capital assets such as rolling stock; and (3) a 15.8% increase, or \$3.9 million, in our U.S. commercial business as a result of several new programs for large retailers. The amount of gross merchandise volume increased \$33.2 million, or 35.4%, to \$126.8 million for the three months ended December 31, 2010 from \$93.6 million for the three months ended December 31, 2009, primarily due to (1) the growth in our U.S. commercial and DoD businesses discussed above; (2) a 13.9% increase, or \$2.6 million, in our state and local government (GovDeals) business; and (3) the acquisition of Network International, completed on June 15, 2010, which utilizes the consignment model.

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Cost of goods sold (excluding amortization). Cost of goods sold (excluding amortization) increased \$6.0 million, or 22.2%, to \$32.9 million for the three months ended December 31, 2010 from \$26.9 million for the three months ended December 31, 2009. As a percentage of revenue, cost of goods sold (excluding amortization) increased to 42.0% from 41.3%. These increases are primarily due to expenses associated with our U.S. commercial business as a result of the growth discussed above, which was primarily under the purchase model.

Profit-sharing distributions. Profit-sharing distributions increased \$1.6 million, or 18.1%, to \$10.6 million for the three months ended December 31, 2010 from \$9.0 million for the three months ended December 31, 2009, primarily due to the growth in our scrap business discussed above. As a percentage of revenue, profit-sharing distributions decreased to 13.5% from 13.8%.

Technology and operations expenses. Technology and operations expenses increased \$1.2 million, or 10.2%, to \$13.3 million for the three months ended December 31, 2010 from \$12.1 million for the three months ended December 31, 2009, primarily due to increases in staff and temporary wages, including stock based compensation, and consultant fees associated with technology infrastructure projects. As a percentage of revenue, technology and operations expenses decreased to 16.9% from 18.5%, primarily due to the increase in revenue, while leveraging our fixed costs, such as distribution centers.

Sales and marketing expenses. Sales and marketing expenses increased \$1.4 million, or 29.4%, to \$6.0 million for the three months ended December 31, 2010 from \$4.6 million for the three months ended December 31, 2009. As a percentage of revenue, sales and marketing expenses increased to 7.7% from 7.1%. These increases are primarily due to (1) expenses of \$0.5 million in staff wages, including stock based compensation; and (2) expenses of \$0.7 million associated with Network International, which was acquired on June 15, 2010.

General and administrative expenses. General and administrative expenses increased \$0.8 million, or 13.4%, to \$6.7 million for the three months ended December 31, 2010 from \$5.9 million for the three months ended December 31, 2009, primarily due to (1) \$0.6 million in staff wages, including stock based compensation; and (2) \$0.2 million in business development costs. As a percentage of revenue, general and administrative expenses decreased to 8.6% from 9.1%, primarily due to the increase in revenue while leveraging our fixed costs, such as corporate staff.

Amortization of contract intangibles. Amortization of contract intangibles was \$0.2 million for the three months ended December 31, 2010 and 2009, as a result of our DoD Scrap Contract award during June 2005. This contract required us to purchase the rights to operate the scrap operations of the DoD during the seven-year base term of the contract. The intangible asset created from the \$5.7 million purchase is being amortized on a straight-line basis over 84 months, which began in August 2005.

Depreciation and amortization expenses. Depreciation and amortization expenses increased \$0.3 million, or 30.5%, to \$1.2 million for the three months ended December 31, 2010 from \$0.9 million for the three months ended December 31, 2009, primarily due to additional depreciation expense resulting from the purchase of \$3.7 million of property and equipment during the fiscal year ended September 30, 2010.

Acquisition costs. Acquisition costs were \$4.7 million for the three months ended December 31, 2010 and \$0 for the three months ended December 31, 2009, as a result of our acquisition of Network International, Inc. on June 15, 2010. The acquisition price included an upfront cash payment of \$7.5 million and an earn-out payment. Under the terms of the agreement, the earn-out is based on EBITDA earned by Network International, Inc. during each of the three six month periods after the closing date of the acquisition through December 31, 2011. We estimated

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the fair value of the earn-out at the time of the acquisition to be \$2.8 million out of a possible total earn out payment of \$7.5 million. Upon review of the estimate as of December 31, 2010, we determined that the operating results of Network International are exceeding original estimates significantly, and have estimated that the full \$7.5 million earn out payment is likely based on the last six months of operating history and estimates for the next 12 months. Therefore, we have recorded an additional liability of \$4.7 million as of December 31, 2010 and reflected this increase in the statement of operations for the three months ended December 31, 2010 in accordance with new authoritative guidance related to business combinations issued by the FASB in December 2007, which we adopted for fiscal year 2010.

Interest income and other (expense), net. Interest income and other (expense), net was consistent at \$21 thousand of expense for the three months ended December 31, 2010 and \$14 thousand of expense for the three months ended December 31, 2009.

Provision for income tax expense. Income tax expense decreased \$1.2 million, or 47.4%, to \$1.4 million for the three months ended December 31, 2010 from \$2.6 million for the three months ended December 31, 2009, primarily due to the decrease in income before provision for income taxes.

Net income. Net income decreased \$1.5 million, or 53.0%, to \$1.4 million for the three months ended December 31, 2010 from \$2.9 million for the three months ended December 31, 2009.

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Liquidity and Capital Resources

Historically, our primary cash needs have been working capital (including capital used for inventory purchases), which we have funded primarily through cash generated from operations. As of December 31, 2010, we had approximately \$48.5 million in cash and cash equivalents, \$32.9 million in short-term investments and \$24.3 million available under our \$30.0 million senior credit facility, due to issued letters of credit for \$5.7 million; \$1.0 million of our availability under this facility is set aside as a contractual obligation under our DoD Scrap Contract.

On December 2, 2008, our Board of Directors approved a \$10.0 million share repurchase program. Under the program, we are authorized to repurchase the issued and outstanding shares of common stock. Share repurchases may be made through open market purchases, privately negotiated transactions or otherwise, at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements and other market conditions. The repurchase program may be discontinued or suspended at any time, and will be funded using our available cash. On February 2, 2010, our Board of Directors approved an additional \$10.0 million for the share repurchase program. On November 30, 2010, our Board of Directors approved an additional \$10.0 million for the share repurchase program. Our Board of Directors reviews the share repurchase program periodically, the last such review having occurred in November 2010. During the year ended September 30, 2009, 707,462 shares were purchased under the program for approximately \$3,874,000. During the year ended September 30, 2010, 1,225,019 shares were purchased under the program for approximately \$14,471,000. During the three months ended December 31, 2010, 229,575 shares were purchased under the program for approximately \$3,541,000. As of December 31, 2010, approximately \$8,114,000 may yet be expended under the program.

Substantially all of our sales are recorded subsequent to receipt of payment authorization, utilizing credit cards, wire transfers and PayPal, an Internet based payment system, as methods of payments. As a result, we are not subject to significant collection risk, as goods are generally not shipped before payment is received.

Changes in Cash Flows: Three Months Ended December 31, 2010 Compared to Three Months Ended December 31, 2009

Net cash provided by operating activities was \$6.8 million for the three months ended December 31, 2010 and \$3.7 million for the three months ended December 31, 2009. For the three months ended December 31, 2010, net cash provided by operating activities primarily consisted of net income of \$1.4 million, depreciation and amortization expense of \$1.4 million, stock compensation expense of \$2.2 million and a net increase in accounts payable, accrued expenses and other liabilities of \$4.3 million primarily due to an increase in customers payable resulting from the growth of our consignment model, offset in part by a net increase in accounts receivable, inventory and prepaid assets of \$2.4 million and provision for inventory allowance and doubtful accounts of \$0.1 million, net. For the three months ended December 31, 2009, net cash provided by operating activities primarily consisted of net income of \$2.9 million, depreciation and amortization expense of \$1.1 million, stock compensation expense of \$1.7 million and a net increase in accounts payable, accrued expenses and other liabilities of \$1.6 million, offset in part by a net increase in accounts receivable, inventory and prepaid assets of \$3.6 million.

Net cash used in investing activities was \$1.6 million for the three months ended December 31, 2010 and \$8.8 million for the three months ended December 31, 2009. Net cash used in investing activities for the three months ended December 31, 2010 consisted primarily of capital expenditures of \$2.0 million for purchases of equipment and leasehold improvements, offset in part by net sales of short-term investments of \$0.4 million. Net cash used in investing activities for the three months ended December 31, 2009 consisted primarily of net purchases of short-term investments of \$7.6 million and capital expenditures of \$1.2 million for purchases of equipment and leasehold improvements.

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Net cash provided by financing activities was \$0.1 million for the three months ended December 31, 2010 and net cash used in financing activities was \$5.0 million for the three months ended December 31, 2009. Net cash provided by financing activities for the three months ended December 31, 2010 consisted primarily of proceeds from the exercise of common stock options including the tax benefit of \$3.6 million, offset in part by \$3.5 million for stock repurchases. Net cash used in financing activities for the three months ended December 31, 2009 consisted primarily of \$5.1 million for stock repurchases, offset in part by proceeds from the exercise of common stock options including the tax benefit of \$0.1 million.

Capital Expenditures. Our capital expenditures consist primarily of computers and purchased software, office equipment, furniture and fixtures, and leasehold improvements. The timing and volume of such capital expenditures in the future will be affected by the addition of new customers or expansion of existing customer relationships. We expect capital expenditures to range from \$4.0 million to \$4.5 million in the fiscal year ending September 30, 2011. We intend to fund those expenditures primarily from operating cash flows. Our capital expenditures for the three months ended December 31, 2010 were \$2.0 million. As of December 31, 2010, we had no outstanding commitments for capital expenditures.

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Senior credit facility. We maintain a \$30.0 million senior credit facility due April 30, 2013. The senior credit facility bears an annual interest rate of 30 day LIBOR plus 1.25%. As of December 31, 2010, we had no outstanding indebtedness under our senior credit facility and our borrowing availability was \$24.3 million due to issued letters of credit for \$5.7 million; \$1.0 million of our availability under this facility is set aside as a contractual obligation under our DoD Scrap Contract. The obligations under our senior credit facility are unconditionally guaranteed by us and each of our existing and subsequently acquired or organized subsidiaries (other than our subsidiary organized to service our DoD Scrap Contract) and secured on a first priority basis by security interests (subject to permitted liens) in substantially all assets owned by us, and each of our other domestic subsidiaries, subject to limited exceptions. The Agreement contains certain financial and non-financial restrictive covenants including, among others, the requirements to maintain a minimum level of earnings before interest, income taxes, depreciation and amortization (EBITDA) and a minimum debt coverage ratio. Our credit agreement contains a number of affirmative and restrictive covenants including limitations on mergers, consolidations and dissolutions, sales of assets, investments and acquisitions, indebtedness and liens, and dividends and other restricted payments. As of December 31, 2010, we were in full compliance with the terms and conditions of our credit agreement.

We believe that our existing cash and cash equivalents and short term investments, will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our rate of revenue growth, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the development and deployment of new marketplaces, the introduction of new value added services and the costs to establish additional distribution centers. Although we are currently not a party to any definitive agreement with respect to potential investments in, or acquisitions of, complementary businesses, products or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased interest expense and could result in covenants that would restrict our operations. There is no assurance that such financing, if required, will be available in amounts or on terms acceptable to us, if at all.

Off-Balance Sheet Arrangements

We do not have any transactions, obligations or relationships that could be considered material off-balance sheet arrangements.

New Accounting Pronouncements

In December 2010, the FASB issued new authoritative guidance related to goodwill impairment. This guidance changes the accounting for goodwill impairment by requiring the step 2 test on goodwill impairment of entities that have a zero or negative carrying amount, whereas previously if an entity had a zero or negative carrying amount and it was determined that the entity had a value greater than zero; step 1 was sufficient, resulting in no requirement to perform step 2 testing and no impairment was recorded. The new guidance is effective for fiscal years (and interim periods within those fiscal years) beginning after December 15, 2010. Early adoption is not permitted so this will not be applicable for us until the first quarter of fiscal 2012. Any impairment charges upon adoption would be recognized as a cumulative-effect adjustment to retained earnings and any impairment charges thereafter would run through current earnings. We are currently evaluating the impact, if any, that this guidance will have upon adoption related to our UK subsidiary, as we currently have a negative carrying amount related to operating losses.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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Interest rate sensitivity. We did not have any debt as of December 31, 2010 and September 30, 2010 and thus do not have any related interest rate exposure. Our investment policy requires us to invest funds in excess of current operating requirements. The principal objectives of our investment activities are to preserve principal, provide liquidity and maximize income consistent with minimizing risk of material loss.

As of December 31, 2010, our cash and cash equivalents consisted primarily of money market funds and our short term investments consisted primarily of highly rated short term bonds. The recorded carrying amounts of cash and cash equivalents approximate fair value due to their short maturities. Our interest income is sensitive to changes in the general level of interest rates in the United States, particularly since the majority of our investments are short-term in nature. Due to the nature of our short-term investments, which have a duration of three to twelve months, we have concluded that we do not have material market risk exposure.

Exchange rate sensitivity. We consider our exposure to foreign currency exchange rate fluctuations to be minimal, as less than three percent of our GMV is denominated in foreign currencies. We have not engaged in any hedging or other derivative transactions to date.

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Item 4. Controls and Procedures.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

During the most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

As of December 31, 2010, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at the reasonable assurance level.

Table of Contents**PART II OTHER INFORMATION****Item 1. Legal Proceedings.**

From time to time, we may become involved in litigation relating to claims arising in the ordinary course of our business. There are no claims or actions pending or threatened against us that, if adversely determined, would in our judgment have a material adverse effect on us.

Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the factors set forth in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended September 30, 2010, which could materially affect our business, financial condition or future results. The risks described in our Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Item 2. Purchases of Equity Securities by the Issuer.**Issuer Purchases of Equity Securities**

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1) | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs(1) |
|------------------------------------|-------------------------------------|---------------------------------|---|---|
| October 1 to October 31, 2010 | | | | |
| November 1 to November 30, 2010 | | | | |
| December 1 to December 31, 2010 | 229,575 \$ | 15.42 | 229,575 \$ | 8,114,000 |
| Total | 229,575 \$ | 15.42 | 229,575 \$ | 8,114,000 |

(1) On December 2, 2008, our Board of Directors approved a share repurchase program, under which we were authorized to repurchase up to \$10.0 million of our issued and outstanding shares of common stock. On February 2, 2010, our Board of Directors approved an additional \$10.0 million for the share repurchase program. On November 30, 2010, our Board of Directors approved an additional \$10.0 million for the share repurchase program.

Item 6. Exhibits.

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| Exhibit No. | Description |
|--------------------|---|
| 3.1 | Fourth Amended and Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.1 to Amendment No. 2 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on January 17, 2006. |
| 3.2 | Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.2 to Amendment No. 2 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on January 17, 2006. |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934. |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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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 on February 4, 2011.

LIQUIDITY SERVICES, INC.
(Registrant)

By: /s/ William P. Angrick, III
William P. Angrick, III
*Chairman of the Board of Directors
and Chief Executive Officer*

By: /s/ James M. Rallo
James M. Rallo
Chief Financial Officer and Treasurer