

LIQUIDITY SERVICES INC  
Form 10-K  
December 11, 2009

Use these links to rapidly review the document

[TABLE OF CONTENTS](#)

[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

---

**FORM 10-K**

(Mark One)

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

For the fiscal year ended September 30, 2009

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)

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

**None**

Securities Registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$.001 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No

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 Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.05 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is 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. (Check One):

Large accelerated filer       Accelerated filer       Non-accelerated filer       Smaller reporting company   
(Do not check if a 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

Aggregate market value of voting and non-voting common equity held by non-affiliates of the registrant as of March 31, 2009 based upon the closing price of the common stock as reported by The NASDAQ Stock Market on such date, was approximately \$181,799,016.

The number of shares outstanding of the issuer's common stock, par value \$.001 per share, as of December 11, 2009 was 27,635,892.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement relating to its 2010 Annual Stockholders' Meeting, to be filed subsequently, are incorporated by reference into Part III of this Form 10-K.

---

Table of Contents

## INDEX

## TABLE OF CONTENTS

Item	Description	Page
<u>1.</u>	<u>Business</u>	<u>1</u>
<u>1A.</u>	<u>Risk Factors</u>	<u>17</u>
<u>1B.</u>	<u>Unresolved Staff Comments</u>	<u>29</u>
<u>2.</u>	<u>Properties</u>	<u>29</u>
<u>3.</u>	<u>Legal Proceedings</u>	<u>29</u>
<u>4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	<u>29</u>
	<b><u>PART II</u></b>	
<u>5.</u>	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>30</u>
<u>6.</u>	<u>Selected Financial Data</u>	<u>31</u>
<u>7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>35</u>
<u>7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>51</u>
<u>8.</u>	<u>Financial Statements and Supplementary Data</u>	<u>51</u>
<u>9.</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>51</u>
<u>9A.</u>	<u>Controls and Procedures</u>	<u>51</u>
<u>9B.</u>	<u>Other Information</u>	<u>54</u>
	<b><u>PART III</u></b>	
<u>10.</u>	<u>Directors and Executive Officers of the Registrant</u>	<u>55</u>
<u>11.</u>	<u>Executive Compensation</u>	<u>55</u>
<u>12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>55</u>
<u>13.</u>	<u>Certain Relationships and Related Transactions</u>	<u>55</u>
<u>14.</u>	<u>Principal Accounting Fees and Services</u>	<u>55</u>
	<b><u>PART IV</u></b>	
<u>15.</u>	<u>Exhibits, Financial Statement Schedule</u>	<u>56</u>
	<u>Signatures</u>	<u>84</u>

---

Table of Contents

Unless the context requires otherwise, references in this report to "we," "us," the "Company" and "our" refer to Liquidity Services, Inc. and its subsidiaries.

**PART I**

**Item 1. Business.**

**Overview**

We operate several leading online auction marketplaces 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, and specialty equipment. Our online auction marketplaces are [www.liquidation.com](http://www.liquidation.com), [www.govliquidation.com](http://www.govliquidation.com), [www.govdeals.com](http://www.govdeals.com) and [www.liquibiz.com](http://www.liquibiz.com). We also operate a wholesale industry portal, [www.goWholesale.com](http://www.goWholesale.com), that connects advertisers with buyers seeking products for resale and related business services.

We believe our ability to optimize our clients' net recovery and supply chain for surplus and salvage assets generates a continuous flow of goods from our corporate and government sellers. This valuable and reliable flow of goods in turn attracts an increasing number of professional buyers to our marketplaces. During fiscal year 2009, the number of registered buyers grew from approximately 999,000 to approximately 1,202,000, or 20.3%. During the past three fiscal years, we have conducted over 1,052,000 online transactions generating approximately \$949 million in gross merchandise volume or GMV. We believe the continuous flow of goods in our marketplaces attracts a growing buyer base which creates a virtuous cycle for our buyers and sellers.

In the fiscal year ended September 30, 2009, we generated GMV of \$356.0 million and revenue of \$236.3 million through multiple sources, including transaction fees from sellers and buyers, revenue sharing arrangements, value-added service charges and online advertising fees. Our revenue has grown at a compound annual growth rate of approximately 28% since fiscal year 2005. Additionally, we have been profitable and cash flow positive since fiscal year 2003.

**Industry Overview**

While a well-established forward supply chain exists for the procurement of assets, most manufacturers, retailers, corporations and government agencies have not made significant investments in their reverse supply chain process or systems. The reverse supply chain addresses the redeployment and remarketing of surplus and salvage assets. These assets generally consist of retail customer returns, overstock products and end-of-life goods or capital assets from both the corporate and government sectors. According to the National Retail Federation, a retail industry association, the total value of merchandise returned in the United States for 2009 is estimated to be \$185 billion, up approximately 4% from \$178 billion in 2007.

The supply of surplus and salvage assets in the reverse supply chain results from a number of factors, including:

*Supply chain inefficiencies.* Forecasting inaccuracies, manufacturer overruns, cancelled orders, evolving market preferences, discontinued product lines, merchandise packaging changes and seasonal fluctuations result in the growth of surplus assets.

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

*Product innovation.* Continuous innovation in technology products, such as computer and office equipment, consumer electronics, and personal communication and entertainment devices, results in a continuous flow of surplus assets.

*Return policies of large national and online retailers.* The flexible return practices of many large national retailers and online shopping sites result in a continuous supply of returned merchandise, a significant portion of which must be liquidated.

*Compliance with government regulations.* An increasingly stringent regulatory environment necessitates the verifiable recycling and remarketing of surplus assets that would otherwise be disposed of as waste.

*Increasing focus by corporate and government agencies to seek green solutions for surplus assets.* Most organizations appreciate the growing need to be environmentally friendly by improving their management of end of life or surplus goods, including creating the need to repurpose or efficiently redistribute surplus and capital assets to minimize waste and maximize value for themselves and the communities they serve.

Organizations that manufacture, distribute, sell or use finished goods regularly need to dispose of excess inventory or returned merchandise. We believe the management and remarketing of surplus assets traditionally has been an inefficient process. While many organizations spend considerable resources developing systems and channels supporting the flow of finished goods to their core customers, we believe that many have not historically dedicated significant resources to the reverse supply chain. Factors contributing to these inefficiencies in the reverse supply chain include the lack of:

a centralized and global marketplace to sell bulk products in the reverse supply chain;

awareness of effective methods and mechanisms for disposal of surplus assets;

experience in managing the reverse supply chain to seek optimal net returns and improve gross margins; and

real time market data on surplus assets as they move through the final steps of the product life cycle.

Traditional methods of surplus asset disposition include ad-hoc, negotiated direct sales, utilization of individual brokers or sales agents and live on-site auctions. We believe these solutions specializing in surplus or underperforming asset disposition are generally highly fragmented, geographically dispersed and poorly integrated with supply chain operations. The manual, negotiated and geographically dispersed nature of traditional surplus resale methods results in a lack of pricing transparency for offered goods and a lower number of potential buyers and bids, which we believe typically lead to lower recovery for sellers.

A significant number of professional buyers seek surplus and salvage assets to sustain their operations and end customers. They include online and offline retailers, convenience and discount stores, value-added resellers such as refurbishers and scrap recyclers, import and export firms and small businesses. Traditionally, these buyers have had limited access to a reliable flow of surplus goods and assets, relying instead on their own network of industry contacts and fixed-site auctioneers to locate, evaluate and purchase specific items of interest. Traditional methods are inefficient for buyers due to the lack of:

global access to an available continuous supply of desired goods and assets;

efficient and inexpensive sourcing processes;

Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

a professionally managed central marketplace with transparent, high quality services;

detailed information and product description for the offered goods; and

pricing transparency or ability to compare asset prices.

Table of Contents

The Internet is a global medium enabling millions of people worldwide to share information, communicate and conduct business electronically. International Data Corporation (IDC), a provider of global IT research and advice, estimates 1.4 billion people used the Internet on a regular basis during 2008. This number is expected to surpass 1.9 billion by 2012 or 30% of the world's population. (Source: IDC's Digital Marketplace Model and Forecast). We believe professional buyers of surplus and salvage assets increasingly will use the Internet to identify and source goods available for immediate purchase.

**Our Solution**

Our solution is comprised of our online auction marketplaces, value-added services and our wholesale search and advertising portal. Our marketplaces and services are designed to provide sellers with a comprehensive solution to quickly bring surplus assets to market and enhance the financial value realized from the sale of these surplus assets while providing buyers with confidence in the reliable flow of goods they purchase. We provide our sellers access to several liquid marketplaces with over one million professional buyers and a suite of services and logistics capabilities to efficiently manage our clients' reverse supply chain. We seek the optimal methods to maximize our clients' net recovery using channel strategies and dedicated programs to deliver transparent, sustained value.

Through our relationships with sellers, we provide buyers convenient access to a substantial and continuous flow of surplus and salvage assets. We provide buyers with products in over 500 categories in lot sizes ranging from full truck loads to pallets, packages and individual items. Our solution combines leading online marketplaces with a full suite of integrated sales, marketing, merchandising, fulfillment, payment collection, dispute mediation and logistics services. We provide buyers a convenient method for sourcing surplus and consumer goods. For any given asset, buyers have access to a detailed product description, product manifest, digital images of a product, relevant transaction history regarding the seller, shipping weights, product dimensions and estimated shipping costs to the buyer's location. This enables our solutions to become the primary source for many of our professional buyers and end-users.

The following chart provides a summary of our online marketplace solution:

Table of Contents

We believe our marketplaces benefit over time from greater scale and adoption by our constituents creating a virtual cycle for our buyers and sellers. As of September 30, 2009, we had aggregated approximately 1,202,000 registered buyers in our marketplaces and access to millions of end-users through a range of existing consumer marketplaces. Aggregating this level of buyer demand and market data enables us to generate a continuous flow of goods from corporate and government sellers, which in turn attracts an increasing number of professional buyers. During the fiscal year ended September 30, 2009 we had approximately 2,118,000 auction participants in our online auctions from our registered buyers. During fiscal year 2009, we grew our registered buyer base by 20.3% or approximately 202,000. As buyers continue to discover and use our online trading platform as an effective method to source assets, we believe our marketplaces and value-added solutions become an increasingly attractive sales channel for corporations and government agencies. We believe this self-reinforcing cycle results in greater transaction volume and enhances the value of our marketplaces.

**Competitive Factors**

We have created liquid marketplaces for virtually any type, quantity or condition of surplus or salvage assets. The strengths of our business model include:

*Aggregation of supply and demand for surplus and salvage assets*

Our ability to aggregate sellers and buyers through our marketplaces is a fundamental strength of our business model. Sellers benefit from a liquid, transparent market and the active participation of our large base of professional buyers, which enhances returns. Buyers benefit from our relationships with high-volume, corporate and government sellers, which provides them with continuous access to a comprehensive selection of surplus and salvage assets. Our solution eliminates the need for sellers and buyers to rely on the highly fragmented and geographically dispersed group of traditional liquidators. Instead, sellers and buyers conveniently access our online marketplaces for all of their surplus and salvage asset needs.

*Integrated and comprehensive solution*

Our marketplaces are designed to provide sellers and buyers with a comprehensive solution for the online sale and purchase of surplus and salvage assets. We offer a full suite of value-added services to simplify the sales and supply chain processes for sellers and improve the utility of our marketplaces for buyers. For corporate and government sellers, we provide sales, marketing, logistics and customer support services that are fully integrated with our marketplaces, creating operational and system efficiencies. For many of these sellers, asset disposition is not a core business function to which they desire to dedicate internal resources. With our solution, we manage each step of the transaction and supply chain for our sellers reducing complexity while providing the ability to optimize the client's net financial return in the sale of surplus goods and assets. Sellers simply make goods available at their facilities or deliver them to our distribution centers and we deliver the profits after the sale is completed. Our buyer services include intelligent alerts, search tools, dynamic pricing, shipping and delivery, secure settlement, live customer support and dispute resolution to enable the most effective methods to source assets for their businesses.

*Flexible and aligned transaction model*

We offer three primary transaction models to our sellers: consignment, profit-sharing and purchase. Under these models, our compensation is derived from either the gross or net proceeds received from the sale of the assets. Our consignment and profit-sharing arrangements are designed to maximize returns by aligning our economic interests.

Table of Contents

*Faster transaction cycle times for our seller and buyers*

We believe our marketplace solutions allow sellers to complete the entire sales process more rapidly than through other liquidation methods by generally reducing the complexities in the reverse supply chain and utilizing our multi-channel strategies to optimize recovery and velocity. As a result, sellers are able to reduce surplus or less valuable inventory quickly, generate additional working capital and reduce the cost of carrying unwanted assets. We provide a one stop solution to enable professional buyers of any size throughout the world to purchase assets in an efficient manner. For these buyers, we provide a broad range of services to give them the information necessary to make an informed bid and ensure they quickly and efficiently receive the goods purchased.

*Solutions that promote sustainability and green solutions for improved corporate/government stewardship*

Our solutions provide a range of capabilities that enable corporate and government agencies to directly reduce the amount of waste generated by redistributing end of life products or assets through our solutions improving the net financial recovery generated while positively impacting the communities they serve. In addition, we also enable our sellers and their customers or consumers to reduce consumer electronics waste through our trade-in solutions. In aggregate, some of the world's largest forward thinking retailers and government agencies have significantly enhanced their stewardship of communities and the environment by partnering with us.

**Our Strategy**

Our mission is to provide business and government clients and buying customers the world's most transparent, innovative and effective online marketplaces and integrated services for surplus assets. The key elements of our mission are to continue to:

*Grow our buyer base and increase active buyer participation on our marketplaces*

We intend to increase the active buyer participation within our marketplaces, by attracting new buyers and leveraging our base of existing professional buyers. We intend to attract new buyers by using a variety of online and traditional marketing programs while improving the services and experience for our valued professional buyers. In addition, we plan to use the comprehensive buyer profiles, preferences and transactional data we have compiled over the past several years to enable us to identify and market assets available through our marketplaces to the most likely buyers. We believe these initiatives will help us to increase the total number of auction participants and increase loyalty among our buyer base.

*Increase value and services for existing sellers*

We intend to grow by increasing the number of categories and geographies that we serve to existing sellers. For many of our sellers, we currently handle only a portion of the available supply of their surplus inventory or assets. In recent years, we have developed trusted relationships with large corporations and government agencies that offer significant growth opportunities by increasing our services offered and share of supply of their surplus assets. In addition, we have partnered with our sellers to identify previously unknown (untapped) flows of surplus assets that can effectively generate greater net returns than their current processes and improve their corporate stewardship. For example, on behalf of the U.S. Department of Defense (the "DoD"), we initially handled sales of its surplus personal property classified as "useable" in the United States and have expanded this relationship to include additional property classifications, such as "scrap" property in the United States.

Table of Contents

*Develop new seller relationships*

We intend to build upon our client base of the world's largest retailers and manufacturers, our expertise with the DOD and thousands of municipal clients to attract additional corporate and government sellers to our marketplaces. We believe the vast majority of corporations and government agencies still rely on inefficient, traditional, and less transparent disposition methods for their surplus assets. We believe our demonstrated performance coupled with an expanded sales initiative will allow us to attract additional corporate and government sellers. As part of our sales initiative, we plan to hire additional professionals and increase our marketing and advertising to sellers in our target markets.

*Innovation and Technology Development*

During the past year we embarked on a redesign of our technology to create more personalized and diverse user experiences and tools for our buyer and sellers. Some of these, such as Seller Self-Service, trade in services, and multi-channel optimization, have already enhanced our US commercial business. We intend to develop and introduce new tools to further automate our solution and leverage the scalability of our technology investments across all of our marketplaces. In addition to enhancing the features, experience, and service for our buyers and sellers, we seek to leverage the greater insight we gain with each transaction to enhance the recovery value clients realize in the reverse supply chain.

*Acquire complementary businesses*

We intend to increase our share of the supply of surplus and salvage goods sold by expanding our operations geographically and across new complementary markets. To support this growth, we intend to continue our disciplined and targeted acquisition strategy. Our approach focuses on identifying target companies that will offer us new or complementary areas of expertise, technology advancements, client bases and geographic territories, such as the GovDeals acquisition, which we completed on January 1, 2008 and the Geneva Group acquisition, which we completed on May 1, 2008. In considering each acquisition scenario, we evaluate the merits of the individual opportunity and determine whether to employ a "buy" or "build" strategy.

**Our Marketplaces**

Our online auction marketplaces serve as an efficient and convenient method for the sale of surplus and salvage consumer goods and capital assets. We operate and enable several marketplaces, including the following:

Our *www.liquidation.com* marketplace enables corporations and selected government agencies located in the United States to sell surplus and salvage assets. This leading business to business marketplace and our related services are designed to meet the needs of clients by selling their surplus assets to domestic and international buyers.

Our *www.govliquidation.com* marketplace enables selected federal government agencies to sell surplus and scrap assets. In addition to goods sold on behalf of other federal agencies, the surplus and scrap assets we sell as the exclusive contractor of the Defense Reutilization and Marketing Service of the U.S. Department of Defense are sold in this marketplace. To satisfy the requirements of U.S. federal government agency sellers, this marketplace incorporates additional terms and conditions of sale, such as U.S. Trade Security Controls clearance for the sale of export-controlled property.

Our *www.govdeals.com* marketplace enable local and state government entities including city, county and state agencies as well as school boards and public utilities located in the United States to sell surplus and salvage assets. This marketplace and our related services are

Table of Contents

designed to meet the unique needs of public sector clients selling to domestic and international buyers.

Our *www.liquibiz.com* marketplace enables European-based corporations and government agencies, including the U.K. Ministry of Defense, to sell goods to European and other international buyers. While all of our marketplaces reach a global buyer base, we recognize that high shipping costs can impact the amount a buyer is willing to bid for goods. As a result, we created this marketplace to geographically align European sellers and buyers. We intend to further expand our operations in Europe through our existing facilities in the United Kingdom.

Our online auction marketplaces are designed to address the particular requirements and needs of buyers and sellers. Although our buyers may access and register on a single marketplace, we use numerous cross-marketing and cross-promotional methods to ensure that buyers are exposed to all of our marketplaces and to all product categories in which they have expressed an interest. For example, we display cross-search results for all our marketplaces in response to key word searches in a single marketplace.

In addition to these leading business to business marketplaces, we recognize the need to reach end users for some of the assets our clients have entrusted to us. Over the past year, we have developed the capability to sell products on our client's behalf directly to end-users and/or consumers using a range of existing marketplaces. In addition, we have an established buyer base that seeks to buy in larger quantities than offered through our standard auction platform and we have dedicated sales teams to support their needs. We expect to continue to meet the needs of our clients and to access a growing range of products for all our buyers by enabling our multi-channel strategy to ensure we create the greatest value for assets at the end of the initial product life cycle.

**Our Value-Added Services for Buyers and Sellers**

We have integrated value-added services to simplify the supply chain processes for our buyers and sellers. We believe these services create the greatest operational efficiencies within this element of the supply chain while enabling the greatest value for sellers and buyers with the highest level of confidence and transparency in the services we provide. Additionally, we believe these services improve compliance with the various policies, regulations and sale restrictions of our corporate and government sellers while supporting or greatly enhancing many corporate or government environmental green initiatives.

*Seller services.* We offer value-added services to sellers in three areas: (1) merchandising and channel optimization, (2) logistics and (3) settlement and customer support.

*Merchandising and Channel Optimization* efforts encompass all of the services necessary to prepare merchandise for a successful auction and include the following:

*Channel Optimization* we determine the marketplace and channel sales strategy that creates the greatest value for the individual asset using our real time transaction systems and proprietary data to support ongoing optimization efforts.

*Marketing and promotion* we use a variety of both online and traditional marketing methods to promote our sellers' merchandise and generate the greatest interest in each asset.

*Asset lotting and merchandising* we leverage our industry experience to organize merchandise we receive into size and product combinations that meet buyer preferences within each marketplace and channel.

*Product information enhancement* we photograph and upload digital images of the merchandise to be sold and combine the images in a relevant format. In order to increase

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

the realized sales value, we also research, collect and use supplemental product information to enhance product descriptions.

*Logistics.* We provide logistics services designed to support the receipt, handling, transportation and tracking of merchandise offered through our marketplaces, including the following:

**Distribution centers** we provide sellers with the flexibility of either having us manage the sales process at their location or delivering merchandise to one of our distribution centers.

**Inventory management** sellers benefit from our management and inventory tracking system designed so that merchandise is received, processed and delivered in a timely manner.

**Cataloguing merchandise** we catalogue all merchandise, which enables us to provide useful product information to buyers and sellers. In certain circumstances, we will inspect the merchandise and provide condition descriptions to improve quality and the financial recovery to the client.

**Testing, data wiping, de-labeling and refurbishment** we test products, wipe electronic data, refurbish and remove labels and product markings from merchandise prior to sale in order to add value to the asset and protect sellers' brand equity and distribution relationships.

**Outbound fulfillment** we can arrange for domestic or international shipping for all merchandise, whether it's a small item or container load for export located in one of our distribution centers or at a seller's facility.

*Settlement and customer support.* Settlement and customer support services are designed for successful and reliable completion of transactions and include:

**Buyer qualification** we qualify buyers to ensure their compliance with applicable government or seller mandated terms of sale, as well as to confirm their ability to complete a transaction.

**Collection and settlement** we collect all payments on behalf of sellers prior to delivery of any merchandise and disburse the profits to the seller after the satisfaction of all conditions of a sale.

**Transaction tracking and reporting** we enable sellers and buyers to track and monitor the status of their transactions throughout the sales process. We support the successful completion of each transaction on behalf of the buyer and seller. We provide a range of comprehensive reporting services to sellers upon the completion of a transaction. Our invoicing and reporting tools can be integrated with the seller's information system, providing a more efficient flow of data.

**Customer support and dispute resolution** we provide full customer support throughout the transaction process and dispute resolution for our customers if needed.

*Buyer services.* Many of the services we provide to sellers also benefit buyers by providing them with the information necessary to make a more informed bid and to receive the goods they purchased. Our buyer focused services include the following:

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

Intelligent alerts and recommendations we notify buyers of upcoming auctions based on their registered preferences and prior transaction history. Registered preferences can be as broad as a product category or as specific as a part number or key word. We use this information to generate automated notifications and recommendations whenever we identify a product that fits a buyer's preference, when auctions are nearing conclusion and based on various other parameters to enable our buyers to see the products that have potential interest.

Table of Contents

Search and navigation tools buyers can search our marketplaces for products based on a variety of criteria and personalized settings, including product category, keyword, lot size, product condition, product geographic location and auction ending date.

Dynamic pricing tools, product information, and shipping quotes we offer multiple dynamic pricing tools including outbid notification, automated bid agent and automatic auction extension. In addition, we provide buyers the information they need to make informed decisions, including product, seller performance, and online shipping quotes to help understand their landed cost.

Broad and flexible range of shipping/pick-up options we can provide packaging and shipping services for each transaction, whether it is a small item or container loads for export, including buyer pick-up at our premises for the vast majority of transactions, or support of buyer arranged transportation. We support the most efficient solution for each transaction and each buyer.

Secure settlement and customer support in addition to qualifying sellers, providing several electronic payment options and serving as a trusted market intermediary, we verify transaction completion, which in turn enhances buyer confidence. In addition, we provide full reliable customer support throughout the transaction process.

**Our Wholesale Industry Portal**

In June 2004, we launched *www.goWholesale.com*, a wholesale industry portal supported by advertising and search services. *goWholesale.com* provides buyers of wholesale, surplus or salvage goods with tools to search for goods on the Internet and provides an avenue for manufacturers, drop shippers, distributors, importers and wholesalers to reach professional buyers. *goWholesale.com* also provides a single online destination for buyers to find specific products for resale and related business services. We developed this portal to provide advertisers with the ability to reach our growing network of professional buyers. Additionally, we believe that users of this site may have an interest in products offered in our marketplaces.

Our *goWholesale.com* portal is designed to allow advertisers to reach highly targeted wholesale buyer audiences in a more effective and efficient manner than other major search engine alternatives. Our wholesale industry portal focuses on three broad areas: generating leads for advertisers; providing access to a broad range of industry specific content for professional buyers; and creating an online community for the exchange of information by participants in the wholesale industry.

Each component of our portal delivers a variety of services, including:

<b>Lead generation</b>	<b>Content</b>	<b>Community</b>
Keyword advertising	Wholesale products	Community forum
Banner advertising	Industry news	Seller ratings
Seller directory	Classified ads	Web logs (blogs)
Sponsorship	Trade show directory	Web seminars
Newsletter advertising	Business services	

**Sales and Marketing**

We utilize a direct sales and marketing force to acquire and manage our seller accounts. As of September 30, 2009, we had 97 sales and 30 marketing personnel. Our sales activities are focused primarily on acquiring new sellers and improving the value to existing sellers. Our marketing activities are focused primarily on acquiring new buyers and increasing existing buyer participation.

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

#### *Sales*

Our sales personnel develop seller relationships, establish agreements to provide our services and manage the business accounts on an on-going basis. Our sales team focuses on building long-term relationships with sellers that we believe will generate recurring transactions. They also leverage our years of experience and market data of completed transactions to identify which of our various services would be beneficial to each new or existing seller.

Our sales group is organized to serve three distinct groups of sellers: large corporate accounts, medium to small corporate accounts and government accounts. This approach is based on our experience in understanding and serving the unique needs of each type of seller:

*Large corporate sellers.* These sellers require a customized approach, using a combination of our industry-focused sales team and our value-added services to create a comprehensive solution.

*Medium to small corporate sellers.* These sellers are offered a turn-key solution enabling them to self-serve in our marketplaces by accessing tools and resources such as uploading product photographs and descriptions.

*Government sellers.* These sellers require a customized approach. Sales efforts are both pro-active and re-active, including responding to already structured contract proposal requests and assisting government agencies in developing the appropriate scope of work to serve their needs.

Our sales personnel receive a salary and performance-based commissions.

#### *Marketing*

We use a variety of online and traditional marketing to attract and activate professional buyers to maximize the number of bidders participating in our online marketplaces as well as to support our sales team:

*Buyer acquisition.* We utilize online marketing, including paid search advertising, search engine optimization, affiliate programs and cross promotion on all of our marketplaces to acquire new buyers. We supplement this online marketing with special event print media, classified advertisements and selected direct mail campaigns. Public relations campaigns, participation in trade shows and speaking engagements also complement our overall buyer acquisition efforts.

*Buyer participation.* We use a variety of tools to increase buyer participation, including: targeted opt-in e-mail newsletters that rely on the buyer's stated categories of interest and past bidding or transaction activity; special e-mail alerts highlighting specific products of interest, personalized recommendation engines; and convenient search tools that enable a buyer or prospective buyer to find desired items on our online marketplaces.

*Market research.* In order to better target buyers by industry segment, geographic location or other criteria, our marketing department has gathered data and information from each of the buyer segments we serve. In addition, the marketing department conducts regular surveys to better understand buyers' behavior and needs. We have a privacy policy and have implemented security measures to protect this information.

*Sales support.* Our marketing department creates supporting documentation and research to support our sales team in presenting our company to potential sellers and buyers, including sales brochures, white papers and participation in selected trade shows.

All marketing activities are evaluated based on the level of auction participation in our marketplaces and the cost effectiveness of each action.



Table of Contents

**Technology and Infrastructure**

Our marketplaces are fully web-based and can be accessed from any Internet enabled computer by using a standard web browser. Our technology systems enable us to automate and streamline many of the manual processes associated with finding, evaluating, bidding on, paying for and shipping surplus and salvage assets. The technology and content behind our marketplaces and integrated value-added services were developed in-house by full-time employees, providing us with control over the marketplaces and the ability to make rapid enhancements to better fit the specific needs of our business and customers. Our marketplaces are supported by a common database architecture and a shared system application. This infrastructure provides:

an efficient channel to sell online through a variety of pricing mechanisms (standard auction, sealed bid, Dutch auction and fixed price);

a scalable back office that enables buyers and sellers to efficiently manage transactions among remote business users by utilizing account management tools, including payment collection, invoicing management, shipping and transaction settlement; and

an input/output agnostic platform, including conduits that enable us to integrate seamlessly with partner enterprise applications of sellers and third party service providers.

We have designed our websites and supporting infrastructure to be highly robust and to support new services and increased traffic. Our servers are fully-managed and hosted in a physically and network-secure environment at data centers in Ashburn, Virginia, which is managed by Equinix, Inc., Phoenix, Arizona, which is managed by Limelight Networks, Inc. and in Atlanta, Georgia, which is managed by SunGard, LP. Every critical piece of our application is fully redundant, and we maintain off-site back-up systems as well as a disaster recovery facility. Our network connectivity offers high performance and scalability to accommodate increases in website traffic. Since January 1, 2003, we have experienced no material service interruptions on our online marketplaces.

Our applications support multiple layers of security, including password-protected log-ins, encryption technology to safeguard information transmitted in web sessions and firewalls to help prevent unauthorized access to our network and servers. We devote significant efforts to protecting our systems from intrusion.

**Operations**

Supporting large organizations that have a recurring need to sell surplus and salvage assets requires systematic processes to enhance the financial value and convenience received by our customers. We believe we have integrated all of the required operational processes into our solution to allow our online auctions to run efficiently and to effectively support our buyers and sellers. Our operations group is comprised of three functions: (1) buyer relations, (2) shipping logistics and (3) distribution center operations.

*Buyer relations*

Our buyer relations group supports the completion of buyer transactions by managing the buyer registration and qualification process, answering questions and requests from buyers, collecting buyer payments and resolving disputes. Our websites contain extensive information about buying through our online marketplaces, including an online tutorial regarding the use of our marketplaces, answers to frequently-asked buyer questions and an indexed help section. Buyers are able to contact a customer service representative by e-mail or phone if they need additional support.

Table of Contents

*Shipping logistics*

Our shipping logistics group manages and coordinates inbound and outbound shipping of merchandise for sellers and buyers. We offer, as part of our value-added services, integrated shipping services and price quotes through multiple shipping carriers. In addition, our shipping coordination group personnel monitor the performance and service level of our network of carriers to help ensure speed and quality of service.

*Distribution center operations*

Our distribution center operations group performs selected pre-sale and post-sale value-added services at our distribution centers and at seller locations. These activities include unloading, manifesting and reporting discrepancies for all received assets and sales preparation of offered assets, including merchandising and organizing offered assets, writing product descriptions, capturing digital images and providing additional optional value-added services such as product delabeling, data cleaning/wiping, testing, refurbishment and repackaging. Our distribution center operations group personnel also arrange the outbound shipping or pick-up of purchased assets with our buyers.

**Competition**

The online services market for auctioning or liquidating surplus and salvage assets is competitive and growing rapidly. We currently compete with:

other e-commerce providers, such as GSI Commerce and Overstock.com;

auction websites such as eBay;

government agencies that have created websites to sell surplus and salvage assets; and

traditional liquidators and fixed-site auctioneers.

We expect our market to become even more competitive as traditional and online liquidators and auctioneers continue to develop online and offline services for disposition, redeployment and remarketing of surplus and salvage assets. In addition, manufacturers, retailers and additional government agencies may decide to create their own websites to sell their own surplus and salvage assets and those of third parties. Competitive pressures could harm our business, financial condition and operating results.

Some of our other current and potential competitors have longer operating histories, larger client bases, greater brand recognition and significantly greater financial, marketing and other resources than we do. In addition, some of these competitors may be able to devote greater financial resources to marketing and promotional campaigns, secure merchandise from sellers on more favorable terms, adopt more aggressive pricing or inventory availability policies and devote substantially more resources to website and systems development than we are able to do. Increased competition may result in reduced operating margins and loss of market share. We may not be able to compete successfully against current and future competitors.

**Our Contracts with the U.S. Department of Defense**

We are the exclusive contractor with the Defense Reutilization and Marketing Service, or DRMS, for the sale of surplus and scrap assets of the U.S. Department of Defense, or DoD, in the United States. This relationship provides a significant supply of goods that we offer to our buyer base through our online marketplace [www.govliquidation.com](http://www.govliquidation.com). In support of these contracts, we provide services in over 1 million square feet of military warehouse space at over 150 military bases throughout the United States.

Table of Contents

We have two material contracts with DoD under which we acquire, manage and sell government property. The largest contract was originally awarded in June 2001, and was renewed in December 2008, relates to usable surplus property of DoD turned in to DRMS and located in the United States, Puerto Rico and Guam, such as computers, electronics, office supplies, equipment, aircraft parts, clothing and textiles (the "Surplus Contract"). The second contract was awarded in June 2005 and relates to substantially all scrap property of DoD turned into the DRMS, such as metals, alloys, and building materials. Property sold under the contracts is "demilitarized" prior to sale and does not include weapons or hazardous materials (the "Scrap Contract").

The Surplus Contract accounted for 33.9%, 31.3% and 32.8% of our revenue and 28.8%, 23.0% and 21.8% of our gross merchandise volume for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. We began operating under the Scrap Contract in August 2005, and it accounted for 27.6%, 31.1% and 21.5% of our revenue and for 23.5%, 22.8% and 14.2% of our gross merchandise volume for the fiscal years 2007, 2008 and 2009, respectively. The contracts were awarded in competitive bids conducted by DoD, and we may be required to go through a new competitive bidding process when our existing contracts expire.

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 Contracts, and the DoD was entitled to approximately 80% of the profits. We refer to these disbursement payments to DoD as profit-sharing distributions. As a result of these arrangements, we recognize as revenue the gross proceeds from these sales. 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 September 12, 2006, we entered into a bilateral contract modification under which the DoD agreed to increase our profit-sharing percentage under the original Surplus Contract in exchange for our agreement to implement additional inventory assurance processes and procedures with respect to the sale of demilitarized property. Under the terms of the contract modification, from August 1, 2006 until November 30, 2006, we were entitled to receive 27.5% of the profits under the Surplus Contract and the DoD was entitled to receive 72.5%. For property received from November 30, 2006 through June 18, 2008, we were entitled to receive between 25% and 30.5% of the profits, based on the results of an audit of the effectiveness of the inventory controls we implemented under the contract modification, which is referred to as the Surplus Contract incentive. This incentive is measured quarterly. On June 1, 2007, we agreed, as provided in the modification to the original Surplus Contract that became effective as of September 12, 2006, to provide additional value-added services with respect to demilitarized property that is returned to the DoD for reutilization. In exchange for our agreement to provide these services, the DoD exercised its existing option to increase our share of net proceeds under the original Surplus Contract by 1%. 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 DRMS' acquisition value to be paid for the property. The DoD has broad discretion to determine what property will be made available for sale to us under the new Surplus Contract and may retrieve or restrict property previously sold to us for national security reasons or if the property is otherwise needed to support the mission of the DoD. The new Surplus Contract has a 36 month term, beginning February 2009, with two 12 month renewal options exercisable by the DoD.

Table of Contents

Under the Scrap Contract, we also have a small business performance incentive based on the number of scrap buyers that are small businesses that would allow 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 the 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. The Scrap Contract expires in August 2012, subject to the DoD's right to extend for three additional one-year terms.

These contracts require us to satisfy export control and other regulatory requirements in connection with sales. Specifically, for specified categories of property sold under the contracts that are subject to export controls, we are required to (1) obtain an end-use certificate from the prospective buyer describing the nature of the buyer's business, describing the expected disposition and specific end-use of the property, and acknowledging the applicability of pertinent export control and economic sanctions laws and (2) confirm that each buyer has been cleared to purchase export-controlled items. Applicable export controls include the Export Administration Regulations enforced by the Bureau of Industry and Security ("BIS") of the U.S. Department of Commerce, and the International Traffic In Arms Regulations enforced by the Directorate of Defense Trade Controls ("DDTC") of the U.S. Department of State. Our collection, settlement tools and procedures are designed so that transactions for these categories of property cannot be completed until we receive a completed end-use certificate and confirmation of the buyer's trade security controls clearance. In addition, we do not combine export-controlled property into auction lots with property not subject to export controls.

We are also prohibited from selling property to persons or entities that appear on lists of restricted or prohibited parties maintained by the United States or other governments, including the Specially Designated Nationals and Blocked Persons List maintained by the Office of Foreign Assets Control of the U.S. Department of Treasury and the Entity List maintained by BIS, the Denied Persons List maintained by BIS and the Debarred Parties List maintained by DDTC. In addition, we are prohibited from selling to countries, regimes, or nationals that are the target of applicable economic sanctions or other embargoes. As part of each sale, we collect information from potential customers that our systems cross reference against a list of restricted or prohibited parties and countries, regimes, or nationals that are the target of economic sanctions or other embargoes in order to comply with these restrictions. Failure to satisfy any of these export control and other regulatory requirements could subject us to civil and criminal penalties and administrative sanctions, including termination of the DRMS contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with U.S. federal government agencies.

The Scrap Contract may be terminated by DoD or by us if the rate of return proceeds performance ratios do not exceed specified benchmark ratios for two consecutive quarterly periods and the preceding twelve months. We have never failed to meet the required benchmark ratios during any of the testing periods. DoD also has the right to audit our performance under the contracts. DoD may terminate the contracts and seek other contract remedies in the event of material breaches, provided that it provides us notice and a 30-day opportunity to cure such breaches. The new Surplus Contract contains a provision providing for a mutual termination of the contract for convenience.

**Government Regulation**

We are subject to federal and state consumer protection laws, including laws protecting the privacy of customer non-public information and regulations prohibiting unfair and deceptive trade practices. Furthermore, the growth and demand for online commerce has and may continue to result in more stringent consumer protection laws that impose additional compliance burdens on online companies. Many jurisdictions also regulate "auctions" and "auctioneers" and may regulate online auction services.

Table of Contents

These consumer protection laws and regulations could result in substantial compliance costs and could interfere with the conduct of our business.

In many states, there is currently great uncertainty about whether or how existing laws governing issues such as property ownership, sales and other taxes, auctions and auctioneering, libel and personal privacy apply to the Internet and commercial online services. These issues may take years to resolve. New legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to our business or the application of existing laws and regulations to the Internet and commercial online services could result in significant additional taxes or regulatory restrictions on our business. These potential restrictions could have an adverse effect on our cash flows and results of operations. Furthermore, there is a possibility that we may be subject to significant fines or other payments for any past failures to comply with these requirements.

In connection with our contracts with the U.S. federal government, the U.S. federal government has the right to audit and review our performance on our government contracts, as well as our compliance with applicable laws and regulations. In addition, we sell merchandise under our government contracts, such as scientific instruments, information technology equipment and aircraft parts, that is subject to further government regulations, some of which may require us to obtain an export license in certain circumstances or an end-use certificate from the buyer. In the United States, the sale of this type of merchandise is further regulated by, among others, the U.S. Export Administration Regulations, International Traffic in Arms and the economic sanctions and embargo laws enforced by the Office of Foreign Assets Control Regulations. If a government audit uncovers improper or illegal activities, or if we are alleged to have violated any laws or regulations governing the products we sell under our government contracts, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, denial of export privileges, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with U.S. federal government agencies. See "Risk Factors Unfavorable findings resulting from a government investigation or audit could subject us to a variety of penalties and sanctions, could negatively impact our future operating results and could force us to adjust previously reported operating results."

**Intellectual Property**

We regard our intellectual property, particularly domain names, copyrights and trade secrets, as critical to our success. We rely on a combination of contractual restrictions and common law copyright and trade secret laws to protect our proprietary rights, know-how, information and technology. These contractual restrictions include confidentiality and non-compete provisions. We generally enter into agreements containing these provisions with our employees, contractors and third parties with whom we have strategic relationships. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our intellectual property without our authorization. We currently are the registered owners of several Internet domain names, including *www.liquidation.com*, *www.govliquidation.com*, *www.liquibiz.com*, *www.govdeals.com* and *www.goWholesale.com*. We pursue the registration of our trademarks in the U.S. and internationally. We are pursuing patent protection. Effective patent, copyright, trademarks, trade secret and domain name protection is expensive to maintain and may require litigation to enforce our intellectual property rights. We seek to protect our domain names in an increasing number of jurisdictions and may not be successful in certain jurisdictions.

We rely on technologies that we license from third parties. These licenses may not continue to be available to us on commercially reasonable terms in the future. As a result, we may be required to obtain substitute technology of lower quality or at greater cost, which could materially adversely affect our business, financial condition, results of operations and cash flows.

Table of Contents

We do not believe that our business, sales policies or technologies infringe the proprietary rights of third parties. However, third parties have in the past and may in the future claim that our business, sales policies or technologies infringe their rights. We expect that participants in the e-commerce market will be increasingly subject to infringement claims as the number of services and competitors in the industry grows. Any such claim, with or without merit, could be time consuming, result in costly litigation or an injunction or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements might not be available on terms acceptable to us, or at all or may be prohibited by an injunction. As a result, any such claim of infringement against us could have a material adverse effect upon our business, financial condition, results of operations and cash flows.

**Employees**

As of September 30, 2009, we had 641 U.S. employees, including 115 in sales and marketing, 39 in technology, 52 in customer service, 358 in operations and 77 in finance and administration. In addition, as of that date, we had 57 international employees (located primarily in the United Kingdom), including 12 in sales and marketing, 2 in technology, 7 in customer service, 19 in operations and 17 in finance and administration.

We believe that we have good relationships with our employees. We have never had a work stoppage, and none of our employees is represented under a collective bargaining agreement or by a union.

**Available Information**

Our annual, quarterly and current reports, proxy statements, amendments to those reports and other information are also made available free of charge on our website [www.liquidityservicesinc.com](http://www.liquidityservicesinc.com), as soon as reasonably practicable after we electronically file these materials with, or furnish them to, the SEC. We use our website as a channel of distribution for material company information. Important information, including news releases, analyst presentations and financial information regarding the Company is routinely posted on and accessible at [www.liquidityservices.com](http://www.liquidityservices.com).

**Cautionary Note Regarding 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 those listed in Part I, Item 1A ("Risk Factors") and in our other filings with the Securities and Exchange Commission (SEC) from time to time. 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 apply only as of the date of this Annual Report 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 Annual Report or to reflect the occurrence of unanticipated events.

Table of Contents

**Item 1A. Risk Factors.**

*You should carefully consider the risks described below, together with all of the other information in this Annual Report, including the consolidated financial statements and related notes, before making an investment decision with respect to our common stock. If any of the following risks occur, our business, financial condition or operating results could suffer. As a result, the trading price of our common stock could decline and you may lose all or part of your investment in our common stock. The risks and uncertainties described below are not the only significant risks we may face. Other events that we do not currently anticipate or that we currently deem immaterial also may affect our results of operations and financial condition.*

**We depend on contracts with the United States Department of Defense for a significant portion of our revenue, and if our relationship with this customer is disrupted, we would experience a significant decrease in revenue and income.**

We have two material contracts with the Defense Reutilization and Marketing Service, or DRMS, under which we acquire, manage and sell surplus and scrap property of the DoD. If our relationship with the DoD is impaired, we are not awarded new DoD contracts when our current contracts expire, any of our DoD contracts are terminated or the supply of assets under the contracts significantly decreased, we would experience a significant decrease in revenue and have difficulty generating income. The Surplus Contract accounted for 33.9%, 31.3% and 32.8% of our revenue and 28.8%, 23.0% and 21.8% of our GMV for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. The Scrap Contract accounted for 27.6%, 31.1% and 21.5% of our revenue and for 23.5%, 22.8% and 14.2% of our GMV in fiscal year 2007, 2008 and 2009, respectively. We believe that these contracts will continue to be the source of a significant portion of our revenue and GMV during their respective terms. The Surplus Contract has a three-year base term that expires in February 2012, subject to the DoD's right to extend for two additional one-year terms. The Scrap Contract has a seven-year base term that expires in August 2012, subject to the DoD's right to extend for three additional one-year terms. The contracts were awarded by the DoD through a competitive bidding process, and we may be required to go through a new competitive bidding process when our existing contracts expire.

Our Surplus Contract with the DoD allows either party to terminate the contract for convenience. Although our Scrap Contract does not allow the DoD to terminate for convenience, it requires us to meet specified performance benchmarks. The Scrap Contract may be terminated by the DoD if rate of return performance ratios do not exceed specified benchmark ratios for two consecutive quarterly periods and the preceding twelve months. Although, to date, we have never failed to meet the required benchmark ratios during any of the testing periods, we cannot assure you that we will meet the performance benchmarks in the future. The DoD also has the right, after giving us notice and a 30 day opportunity to cure, to terminate the contracts and seek other contract remedies in the event of material breaches.

**Unfavorable findings resulting from a government investigation or audit could subject us to a variety of penalties and sanctions, could negatively impact our future operating results and could force us to adjust previously reported operating results.**

In the past, the Government Accountability Office (GAO) has cited weaknesses in DoD excess inventory control procedures and lax security at selected DoD facilities with respect to surplus property. In July 2006, the GAO asserted that we failed to verify the appropriate DoD regulatory classifications for certain items we sold and, as a result, we sold items we should have instead returned to the DoD. We do not believe that we have a contractual responsibility under our DoD contracts to assign these classifications; we believe that the DoD has the contractual obligation to assign these classifications. In July 2006, the GAO also identified buyers that collectively purchased sensitive military items and stated that the GAO was referring these sales to federal law enforcement agencies for investigation. These

Table of Contents

buyers may have acquired these sensitive military items from us. It is possible that other government and law enforcement agencies may also investigate these sales, our company and our activities under our DoD contracts. If an investigation alleges that we engaged in improper or illegal activities, we could be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with U.S. federal government agencies. We could also suffer serious harm to our reputation if allegations of impropriety are made against us, whether or not these allegations have merit.

The federal government has the right to audit our performance under our government contracts. Any adverse findings from audits or reviews of our performance under our contracts could result in a significant adjustment to our previously reported operating results. For example, some of our DoD contracts provide that we share sales profits with the government. The federal government may disagree with our calculation of the profits realized from the sales of government surplus assets and may require us to increase profit-sharing payments to the government that have been made in the past. If this occurs, our past operating margins may be reduced. The results of an audit by the government could significantly limit the volume and type of merchandise made available to us under our contracts with the DoD, resulting in lower gross merchandise volume, revenue, and profitability for our company. If such a government audit uncovers improper or illegal activities, we could be subject to the civil and criminal penalties, administrative sanctions and reputational harm described above. If, as the result of such an audit, or for any other reason, we are suspended or debarred from contracting with the federal government generally, or any specific agency, if our reputation or relationship with government agencies is impaired, or if the government otherwise ceases doing business with us or significantly decreases the amount of business it does with us, our revenue and profitability would substantially decrease.

**The success of our business depends on our ability to successfully obtain a supply of merchandise for our buyers and to attract and retain active professional buyers to create sufficient demand for our sellers.**

Our ability to increase our revenue and maintain profitability depends on whether we can successfully expand the supply of merchandise available for sale on our online marketplaces and attract and retain active professional buyers to purchase the merchandise. Our ability to attract sufficient quantities of suitable merchandise and new buyers will depend on various factors, some of which are out of our control. These factors include our ability to:

offer sellers liquid marketplaces for their surplus and salvage assets;

offer buyers a sufficient supply of merchandise;

develop and implement effective sales and marketing strategies;

comply with regulatory or corporate seller requirements affecting marketing and disposition of certain categories of merchandise;

efficiently catalogue, handle, store, ship and track merchandise; and

achieve high levels of seller and buyer satisfaction with the trading experience.

**We may not be able to compete successfully against existing or future competitors.**

The online services market for auctioning or liquidating surplus and salvage assets is competitive and growing rapidly. Competitive pressures could affect our ability to attract and retain customers, which could decrease our revenue and negatively affect our operating results. We currently compete with:

other e-commerce providers, such as Amazon.com, GSI Commerce and Overstock.com;



Table of Contents

auction websites such as eBay;

government agencies that have created websites to sell surplus and salvage assets; and

traditional liquidators and fixed-site auctioneers.

We expect our market to become even more competitive as traditional and online liquidators and auctioneers continue to develop online and offline services for disposition, redeployment and remarketing of surplus and salvage assets. In addition, manufacturers, retailers and government agencies may decide to create their own websites to sell their own surplus and salvage assets and those of third parties.

Some of our other current and potential competitors have longer operating histories, larger client bases, greater brand recognition and significantly greater financial, marketing and other resources than we do. In addition, some of these competitors may be able to devote greater financial resources to marketing and promotional campaigns, secure merchandise from sellers on more favorable terms, adopt more aggressive pricing or inventory availability policies and devote substantially more resources to website and systems development than we are able to do. Increased competition may result in reduced operating margins and loss of market share. We may not be able to compete successfully against current and future competitors.

**If we fail to manage our growth effectively, our operating results could be adversely affected.**

We have expanded our operations rapidly since our inception in 1999. Although we currently do not have specific plans for any expansion that would require significant capital investment, in the future we plan to expand our operations further by developing new or complementary services, products, or trading formats and enhancing the breadth and depth of our value-added services. We also plan to continue to expand our sales and marketing, technology and client support organizations. In addition, we will likely need to continue to improve our financial and management controls and our reporting systems and procedures. If we are unable to effectively implement these plans and to otherwise manage our expanding operations, we may not be able to execute our business strategy and our operating results could significantly decrease.

**Our quarterly operating results have fluctuated in the past and may do so in the future, which could cause volatility in our stock price.**

Our prior operating results have fluctuated due to changes in our business and the e-commerce industry. Similarly, our future operating results may vary significantly from quarter to quarter due to a variety of factors, many of which are beyond our control. You should not rely on period-to-period comparisons of our operating results as an indication of our future performance. Factors that may affect our quarterly operating results include the following:

the addition of new buyers and sellers or the loss of existing buyers and sellers;

the volume, size, timing and completion rate of transactions in our marketplaces;

changes in the supply and demand for and the volume, price, mix and quality of our supply of surplus and salvage assets;

introduction of new or enhanced websites, services or product offerings by us or our competitors;

implementation of significant new contracts;

changes in our pricing policies or the pricing policies of our competitors;

Table of Contents

changes in the conditions and economic prospects of the e-commerce industry or the economy generally, which could alter current or prospective buyers' and sellers' priorities;

technical difficulties, including telecommunication system or Internet failures;

changes in government regulation of the Internet and e-commerce industry;

event-driven disruptions such as war, terrorism, disease and natural disasters;

seasonal patterns in selling and purchasing activity; and

costs related to acquisitions of technology or equipment.

Our operating results may fall below the expectations of market analysts and investors in some future periods. If this occurs, even temporarily, it could cause volatility in our stock price.

**Our operating results depend on our websites, network infrastructure and transaction processing systems. Service interruptions or system failures could negatively affect the demand for our services and our ability to grow our revenue.**

Any system interruptions that affect our websites or our transaction systems could impair the services that we provide to our sellers and buyers. In addition, our systems may be vulnerable to damage from a variety of other sources, including telecommunications failures, power outages, malicious human acts and natural disasters. Improving the reliability and redundancy of our systems may be expensive, reduce our margins and may not be successful in preventing system failures. Our services are also substantially dependent on systems provided by third parties, over whom we have little control. We have occasionally experienced interruptions to our services due to system failures unrelated to our own systems. Any interruptions or failures of our current systems or our ability to communicate with third party systems could negatively affect the demand for our services and our ability to grow our revenue.

**If we do not respond to rapid technological changes or upgrade our systems, we could fail to grow our business and our revenue could decrease.**

To remain competitive, we must continue to enhance and improve the functionality and features of our e-commerce business. Although we currently do not have specific plans for any upgrades that would require significant capital investment, in the future we will need to improve and upgrade our technology, transaction processing systems and network infrastructure in order to allow our operations to grow in both size and scope. Without such improvements, our operations might suffer from unanticipated system disruptions, slow transaction processing, unreliable service levels, or impaired quality or delays in reporting accurate financial information, any of which could negatively affect our reputation and ability to attract and retain sellers and buyers. We may also face material delays in introducing new services, products and enhancements. The Internet and the e-commerce industry are rapidly changing. If competitors introduce new products and services using new technologies or if new industry standards and practices emerge, our existing websites and our proprietary technology and systems may become obsolete. In addition, the expansion and improvement of our systems and infrastructure may require us to commit substantial financial, operational and technical resources, with no assurance our business will increase. If we fail to respond to technological change or to adequately maintain, expand, upgrade and develop our systems and infrastructure in a timely fashion our ability to grow could be limited and our revenue could decrease.

Table of Contents

**Shipment of merchandise sold in our marketplaces could be delayed or disrupted by factors beyond our control and we could lose buyers and sellers as a result.**

We rely upon third party carriers such as United Parcel Services, or UPS, for timely delivery of our merchandise shipments. As a result, we are subject to carrier disruptions and increased costs due to factors that are beyond our control, including labor difficulties, inclement weather, terrorist activity and increased fuel costs. In addition, we do not have a long-term agreement with UPS or any other third party carriers, and we cannot be sure that our relationship with UPS will continue on terms favorable to us, if at all. If our relationship with UPS is terminated or impaired or if UPS is unable to deliver merchandise for us, we would be required to use alternative carriers for the shipment of products to our buyers. We may be unable to engage alternative carriers on a timely basis or on terms favorable to us, if at all. Potential adverse consequences include:

reduced visibility of order status and package tracking;

delays in merchandise receipt and delivery;

increased cost of shipment; and

reduced shipment quality, which may result in damaged merchandise.

Any failure to receive merchandise at our distribution centers or deliver products to our buyers in a timely and accurate manner could lead to client dissatisfaction and cause us to lose sellers and buyers.

**A significant interruption in the operations of our customer service system or our distribution centers could harm our business and operating results.**

Our business depends, to a large degree, on effective customer service and distribution center operations. We currently staff DoD warehouse distribution space, for which we do not incur leasing costs, as well as leased commercial warehouse distribution space. These operations could be harmed by several factors, including any material disruption or slowdown at our distribution centers resulting from labor disputes, changes in the terms of our underlying lease agreements or occupancy arrangements in the case of government provided facilities, telecommunications failures, power or service outages, human error, terrorist attacks, natural disasters or other events. In addition, space provided to us by the DoD could be re-configured or reduced as a result of the DoD's Base Realignment and Closure initiative or other infrastructure reduction initiatives.

**If we fail to accurately predict our ability to sell merchandise in which we take inventory risk and credit risk, our margins may decline as a result of lower sale prices from such merchandise.**

Under our profit-sharing and purchase model, we purchase merchandise and assume the risk that the merchandise may sell for less than we paid for it. We assume general and physical inventory and credit risk. These risks are especially significant because some of the goods we sell on our websites are characterized by rapid technological change, obsolescence and price erosion, and because we sometimes make large purchases of particular types of inventory. In addition, we do not receive warranties on the goods we purchase and, as a result, we have to resell or dispose of any returned goods. Historically, the number of disposed goods (which includes returned goods that we have not resold) has been less than 2% of the goods we have purchased. To manage our inventory successfully, we need to maintain sufficient buyer demand and sell merchandise for a reasonable financial return. We may miscalculate buyer demand and overpay for the acquired merchandise. In the event that merchandise is not attractive to our buyer base, we may be required to take significant losses resulting from lower sale prices, which could reduce our revenue and margins. For example, under the Surplus Contract, we are obligated to purchase all DoD surplus property at 1.8% of the original acquisition cost, which varies depending on the type of surplus property being purchased. Under the Scrap Contract, we acquire

Table of Contents

scrap property at a per pound price. Recent declines in commodity prices may also reduce the profit we are able to realize in our scrap business. Occasionally, we are not able to sell our inventory for amounts above its cost and we may incur a loss. As we grow our business, we may choose to increase the amount of merchandise we purchase directly from sellers, thus resulting in increased inventory levels and related risk. Any such increase would require the use of additional working capital and subject us to the additional risk of incurring losses on the sale of that inventory.

**A protracted global recession could have a material adverse effect on our operating income, financial condition, cash flows and the trading price of our stock.**

A long-term global recession could reduce the demand for our services while decreasing the prices paid in our auctions and increasing our costs, which could adversely affect the results of our operations. For over a year, financial markets have been experiencing volatility and disruption which has, in recent months, reached unprecedented levels. International efforts to address the current global credit and banking crisis may be unsuccessful in preventing a global recession.

The current worldwide financial crisis has reduced the availability of liquidity and credit to borrowers. Many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers. If our buyers and sellers are unable to obtain financing required to fund their operations, demand for our services may be adversely affected. In addition, this market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies or defaults, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally, which may also adversely affect demand for our services.

**We may be unable to adequately protect or enforce our intellectual property rights, which could harm our reputation and negatively impact the growth of our business.**

We regard our intellectual property, particularly domain names, copyrights and trade secrets, as critical to our success. We rely on a combination of contractual restrictions and copyright and trade secret laws to protect our proprietary rights, know-how, information and technology. Despite these protections, it may be possible for a third party to copy or otherwise obtain and use our intellectual property without authorization or independently develop similar intellectual property.

We currently are the registered owners of several Internet domain names, including *www.liquidation.com*, *www.govliquidation.com*, *www.liquidbiz.com*, *www.govdeals.com* and *www.goWholesale.com*. We pursue the registration of our domain names in the U.S. and internationally. We currently do not have any patents or registered copyrights, but we are pursuing patents. Effective patent, copyright, trademark, service mark, trade secret and domain name protection is expensive to maintain and may require litigation. We seek to protect our domain names in an increasing number of jurisdictions and may not be successful in doing so in certain jurisdictions. Our competitors may adopt trade names or domain names similar to ours, thereby impeding our ability to promote our marketplaces and possibly leading to client confusion. In addition, we could face trade name or trademark or service mark infringement claims brought by owners of other registered or unregistered trademarks or service marks, including trademarks or service marks that may incorporate variations of our marketplace names. Any claims related to our intellectual property or client confusion related to our marketplaces could damage our reputation and negatively impact the growth of our business.

**Our inability to use software licensed from third parties or our use of open source software under license terms that interfere with our proprietary rights could disrupt our business.**

We use software licensed from third parties, including some software, known as open source software that we use without charge. We currently use the following open source software: Linux (an operating system), MySQL (database software), PERL (an interpreter) and Apache (a web server), and

Table of Contents

we may in the future use additional open source software. In the future, these licenses to third party software may not be available on terms that are acceptable to us, or at all. Our inability to use third-party software could result in disruptions to our business, or delays in the development of future services or enhancements of existing services, which could impair our business. In addition, the terms of certain open source software licenses may require us to provide modified versions of the open source software, which we develop, if any, or any proprietary software that incorporates all or a portion of the open source software, if any, to others on unfavorable license terms that are consistent with the open source license term. If we are required to license our proprietary software in accordance with the foregoing, our competitors and other third parties could obtain access to our intellectual property, which could harm our business.

**Assertions that we infringe on intellectual property rights of others could result in significant costs and substantially harm our business and operating results.**

Other parties may assert that we have infringed on their technology or other intellectual property rights. We use internally developed systems and licensed technology to operate our online auction platform and related websites. Third parties could assert intellectual property infringement claims against us based on our internally developed systems or use of licensed third party technology. Third parties also could assert intellectual property infringement claims against parties from whom we license technology. If we are forced to defend against any infringement claims, whether they are with or without merit or are determined in our favor, we may face costly litigation, diversion of technical and management personnel and/or delays in completion of sales. Furthermore, the outcome of a dispute may be that we would need to change technology, develop non-infringing technology or enter into royalty or licensing agreements. A switch to different technology could cause interruptions in our business. Internal development of a non-infringing technology may be expensive and time-consuming, if we are able to successfully develop such technology at all. Royalty or licensing agreements, if required, may be unavailable on terms acceptable to us, or at all. Incurrence of any of these costs could negatively impact our operating results.

**If we do not retain our senior management, we may not be able to achieve our business objectives.**

Our future success is substantially dependent on the continued service of our senior management, particularly William P. Angrick, III, our chief executive officer. We do not have key-person insurance on any of our officers or employees. The loss of any member of our existing senior management team could damage key seller relationships, result in the loss of key information, expertise or know-how, lead to unanticipated recruitment and training costs and make it more difficult to successfully operate our business and achieve our business goals.

**If we are unable to attract and retain skilled employees, we might not be able to sustain our growth.**

Our future success depends on our ability to continue to attract, retain and motivate highly skilled employees, particularly employees with sales, marketing, operations and technology expertise. Competition for employees in our industry is intense. We have experienced difficulty from time to time in attracting the personnel necessary to support the growth of our business, and we may experience similar difficulties in the future. If we are unable to attract, assimilate and retain employees with the necessary skills, we may not be able to grow our business and revenue.

Table of Contents

**Our international operations subject us to additional risks and challenges that could harm our business and our profitability.**

We have begun expanding internationally, and in the future we may do so more aggressively. For the fiscal year ended September 30, 2009, international operations accounted for less than 8% of our revenue. International operations subject us to additional risks and challenges, including:

- the need to develop new seller and buyer relationships;
- difficulties and costs of staffing and managing foreign operations;
- changes in and differences between domestic and foreign regulatory requirements;
- price controls and foreign currency exchange rate fluctuations;
- difficulties in complying with export restrictions and import permits;
- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences;
- lower per capita Internet usage and lack of appropriate infrastructure to support widespread Internet usage;
- political and economic instability; and
- tariffs and other trade barriers.

We cannot assure you that we will be successful in our efforts in foreign countries. Some of these factors may cause our international costs to exceed our domestic costs of doing business. Failure to adequately address these risks could decrease our profitability and operating results.

**We may make acquisitions that require significant resources and could be unsuccessful.**

In the future, we may acquire other businesses, products and technologies to complement our current business. We may not be able to identify, negotiate, finance, complete or integrate any future acquisition successfully. Acquisitions involve a number of risks, including possible adverse effects on our operating results, diversion of management's attention, inability to retain key employees of the acquired business and risks associated with unanticipated events or liabilities, some or all of which could disrupt our business and reduce the likelihood that we will receive the anticipated benefits of the acquisition in the amount or the time frame that we expect.

Should we be unable successfully to integrate a new business, we could be required either to dispose of the operation or restructure the operation. In either event, our business could be disrupted and we may not achieve the anticipated benefits of the acquisition. In addition, future transactions could result in potentially dilutive issuances of our equity securities, the incurrence of debt, contingent liabilities or amortization of expenses, or write-offs of goodwill, any of which could harm our financial condition and operating results. Future transactions may also require us to obtain additional financing, which may not be available on favorable terms or at all.

**We may need additional financing in the future, which may not be available on favorable terms, if at all.**

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

We may need additional funds to finance our operations, as well as to enhance our services, fund our expansion, respond to competitive pressures or acquire complementary businesses or technologies. However, our business may not generate the cash needed to finance such requirements. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our existing stockholders would be reduced, and these securities may have rights, preferences or

Table of Contents

privileges senior to those of our common stock. If adequate funds are not available or are not available on acceptable terms, our ability to enhance our services, fund our expansion, respond to competitive pressures or take advantage of business opportunities would be significantly limited, and we might need to significantly restrict our operations.

**We face legal uncertainties relating to the Internet in general and to the e-commerce industry in particular and may become subject to costly government regulation.**

The laws and regulations related to the Internet and e-commerce are evolving. These laws and regulations relate to issues such as user privacy, freedom of expression, pricing, fraud, quality of products and services, taxation, advertising, intellectual property rights and information security. Laws governing issues such as property ownership, copyrights and other intellectual property issues, taxation, libel and defamation, obscenity and personal privacy could also affect our business. Laws adopted prior to the advent of the Internet may not contemplate or address the unique issues of the Internet and related technologies and it is not clear how they will apply. Current and future laws and regulations could increase our cost of doing business and/or decrease the demand for our services.

**Our auction business may be subject to a variety of additional costly government regulations.**

Many states and other jurisdictions have regulations governing the conduct of traditional "auctions" and the liability of traditional "auctioneers" in conducting auctions, which may apply to online auction services. In addition, certain states have laws or regulations that expressly apply to online auction services. We expect to continue to incur costs in complying with these laws and could be subject to fines or other penalties for any failure to comply with these laws. We may be required to make changes in our business to comply with these laws, which could increase our costs, reduce our revenue, cause us to prohibit the listing of certain items, or otherwise adversely affect our financial condition or operating results.

In addition, the law regarding the potential liability of an online auction service for the activities of its users is not clear. We cannot assure you that users of our websites will comply with our terms and conditions or with laws and regulations applicable to them and their transactions. It is possible that we may be subject to allegations of civil or criminal liability for any unlawful activities conducted by sellers or buyers. Any costs we incur as a result of any such allegations, or as a result of actual or alleged unlawful transactions using our marketplaces, or in our efforts to prevent any such transactions, may harm our opportunities for future revenue growth. In addition, any negative publicity we receive regarding any such transactions or allegations may damage our reputation, our ability to attract new sellers and buyers and our business.

**Certain categories of merchandise sold on our marketplaces are subject to government restrictions.**

We sell merchandise, such as scientific instruments, information technology equipment and aircraft parts, that is subject to export control and economic sanctions laws, among other laws, imposed by the United States and other governments. Such restrictions include the U.S. Export Administration Regulations, the International Traffic in Arms Regulations, and economic sanctions and embargo laws administered by the Office of the Foreign Assets Control Regulations. These restrictions prohibit us from, among other things, selling property to (1) persons or entities that appear on lists of restricted or prohibited parties maintained by the United States or other governments or (2) countries, regimes, or nationals that are the target of applicable economic sanctions or other embargoes. In addition, for specified categories of property sold under our contracts with the DoD, we are required to (1) obtain an end-use certificate from the prospective buyer describing the nature of the buyer's business, describing the expected disposition and specific end-use of the property, and acknowledging the applicability of pertinent export control and economic sanctions laws and (2) confirm that each buyer has been cleared to purchase export-controlled items.

Table of Contents

We may incur significant costs or be required to modify our business to comply with these requirements. If we are alleged to have violated any of these laws or regulations we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with U.S. federal government agencies. In addition, we could suffer serious harm to our reputation if allegations of impropriety are made against us, whether or not true.

**Our business may be harmed if third parties misappropriate our clients' confidential information.**

We retain highly confidential information on behalf of our clients in our systems and databases. Although we maintain security features in our systems, our operations may be susceptible to hacker interception, break-ins and other disruptions. These disruptions may jeopardize the security of information stored in and transmitted through our systems. We may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches. These issues are likely to become more difficult as we expand our operations. If any compromise of our security were to occur, we may lose clients and our reputation, business, financial condition and operating results could be harmed by the misappropriation of confidential client information. In addition, if there is any perception that we cannot protect our clients' confidential information, we may lose the ability to retain existing clients and attract new clients and our revenue could decline.

**If we fail to comply with increasing levels of regulation relating to privacy, our business could suffer harm.**

We are subject to increasing regulation at the federal, state and international levels relating to privacy and the use of personal user information. In addition, several states have proposed or enacted legislation to limit uses of personal information gathered online or require online services to establish privacy policies. Data protection regulations and enforcement efforts may restrict our ability to collect demographic and personal information from users, which could be costly or harm our marketing efforts. Such regulations, along with increased government or private enforcement, may increase the cost of growing our business and require us to expend significant capital and other resources. Our failure to comply with these federal, state and international laws and regulations could subject us to lawsuits, fines, criminal penalties, statutory damages, adverse publicity and other costs could decrease our profitability.

**If one or more states successfully assert that we should collect sales or other taxes on the sale of our merchandise or the merchandise of third parties that we offer for sale on our websites, our business could be harmed.**

We are currently required to pay sales taxes in all states for shipment of goods from our DoD contracts. We also pay sales or other similar taxes in respect of shipments of other goods into states in which we have a substantial presence. In addition, as we grow our business, any new operation in states in which we currently do not pay sales taxes could subject shipments into such states to state sales taxes under current or future laws.

In October 2007, the federal government extended until November 2014 a ban on state and local governments' imposition of new taxes on Internet access or electronic commerce transactions. This ban does not prohibit federal, state or local authorities from collecting taxes on our income or from collecting taxes that are due under existing tax rules. Unless the ban is further extended, state and local governments may begin to levy additional taxes on Internet access and electronic commerce transactions upon the legislation's expiration. An increase in taxes may make electronic commerce transactions less attractive for merchants and businesses, which could result in a decrease in the level of demand for our services.

Table of Contents

Currently, decisions of the U.S. Supreme Court restrict the imposition of obligations to collect state and local sales and use taxes with respect to sales made over the Internet. However, a number of states, as well as the U.S. Congress, have been considering various initiatives that could limit or supersede the Supreme Court's position regarding sales and use taxes on Internet sales. If any of these initiatives resulted in a reversal of the Supreme Court's current position, we could be required to collect sales and use taxes in states other than states in which we currently pay such taxes. A successful assertion by one or more local, state or foreign jurisdictions that the sale of merchandise by us is subject to sales or other taxes, could subject us to material liabilities and increase our costs of doing business. To the extent that we pass such costs on to our clients, doing so could harm our business and decrease our revenue.

**Fraudulent activities involving our websites and disputes relating to transactions on our websites may cause us to lose clients and adversely affect our ability to grow our business.**

We are aware that other companies operating online auction or liquidation services have periodically received complaints of fraudulent activities of buyers or sellers on their websites, including disputes over the quality of goods and services, unauthorized use of credit card and bank account information and identity theft, potential breaches of system security, and infringement of third-party copyrights, trademarks and trade names or other intellectual property rights. We may receive similar complaints if sellers or buyers trading in our marketplaces are alleged to have engaged in fraudulent or unlawful activity. In addition, we may suffer losses as a result of purchases paid for with fraudulent credit card data even though the associated financial institution approved payment. In the case of disputed transactions, we may not be able to require users of our services to fulfill their obligations to make payments or to deliver goods. We also may receive complaints from buyers about the quality of purchased goods, requests for reimbursement, or communications threatening or commencing legal actions against us. Negative publicity generated as a result of fraudulent conduct by third parties or the failure to satisfactorily settle disputes related to transactions on our websites could damage our reputation, cause us to lose clients and adversely affect our ability to grow our business.

**False or defamatory statements transmitted through our services could harm our reputation and affect our ability to attract clients.**

The law relating to the liability of online services companies for information carried on or disseminated through their services is currently unsettled. Claims could be made against online services companies under both the U.S. and foreign law for defamation, libel, invasion of privacy, negligence, copyright or trademark infringement, or other theories based on the nature and content of the materials disseminated through their services. Our *goWholesale.com* website allows users to make comments regarding the online auction industry in general and other users and their merchandise in particular. Although all such comments are generated by users and not by us, we are aware that claims of defamation or other injury have been made against other companies operating auction services in the past and could be made in the future against us for comments made by users. If we are held liable for information provided by our users and carried on our service, we could be directly harmed and may be forced to implement measures to reduce our liability. This may require us to expend substantial resources or discontinue certain service offerings, which could negatively affect our operating results. In addition, the increased attention focused upon liability issues as a result of these lawsuits and legislative proposals could harm our reputation and affect our ability to attract clients.

**Our stock price has been volatile, and your investment in our common stock could suffer a decline in value.**

The current worldwide financial crisis has led to a rapid decline in the overall value of the stock market and increased market volatility. This market turmoil and other broad market and industry

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

factors may adversely affect the market price of our common stock, regardless of our actual operating performance. Other factors that could cause fluctuation in our stock price may include:

actual or anticipated variations in quarterly operating results;

changes in financial estimates by us or by a securities analyst who covers our stock;

publication of research reports about our company or industry;

conditions or trends in our industry;

stock market price and volume fluctuations of other publicly traded companies and, in particular, those whose business involves the Internet and e-commerce;

announcements by us or our competitors of significant contracts, acquisitions, commercial relationships, strategic partnerships or divestitures;

announcements by us or our competitors of technological innovations, new services or service enhancements;

announcements of investigations or regulatory scrutiny of our operations or lawsuits filed against us;

the passage of legislation or other regulatory developments that adversely affect us, our clients or our industry;

additions or departures of key personnel;

sales of our common stock, including sales of our common stock by our directors and officers or specific stockholders; and

general economic conditions and slow or negative growth of related markets.

Volatility in the market price of shares may prevent investors from being able to sell their shares of common stock at prices they view as attractive. In the past, securities class action litigation has often been instituted against companies following periods of volatility in their stock price. This type of litigation could result in substantial costs and divert our management's attention and resources.

#### **Some provisions of our charter, bylaws and Delaware law inhibit potential acquisition bids that you may consider favorable.**

Our corporate documents and Delaware law contain provisions that may enable our board of directors to resist a change in control of our company even if a change in control were to be considered favorable by you and other stockholders. These provisions include:

a staggered board of directors;

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

a prohibition on actions by our stockholders by written consent;

limitations on persons authorized to call a special meeting of stockholders;

the authorization of undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval;

advance notice procedures required for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders; and

the requirement that board vacancies be filled by a majority of our directors then in office.

These provisions could discourage, delay or prevent a transaction involving a change in control of our company. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors of your choosing and cause us to take other corporate actions you desire.

Table of Contents**Item 1B. Unresolved Staff Comments.**

Not Applicable

**Item 2. Properties.**

We do not own any real property. We lease the following properties:

Purpose	Location	Square Feet	Lease Expiration Date
Corporate Headquarters	Washington, D.C.	13,200	January 31, 2013
Administrative	Washington, D.C.	9,300	September 30, 2011
Warehouse	Cranbury, New Jersey	75,500	October 31, 2010
Warehouse	Dallas, Texas	128,700	May 31, 2013
Warehouse	Plainfield, Indiana	187,700	April 30, 2012
Warehouse	Fullerton, California	117,000	July 10, 2011
Warehouse	Sacramento, California	54,600	December 31, 2010
Warehouse	Bentonville, Arkansas	78,000	March 31, 2011
Warehouse	Sterling, Virginia	5,700	May 31, 2010
Headquarters DoD	Scottsdale, Arizona	11,000	September 30, 2013.
Warehouse DoD	Columbus, Ohio	447,300	122,200 will expire on February 28, 2010 and the remaining will expire on September 30, 2012
Warehouse DoD	Oklahoma City, Oklahoma	325,100	September 30, 2012
Headquarters GD	Montgomery, Alabama	6,200	January 1, 2011
Administrative GD	Nashville, Tennessee	1,300	January 31, 2010
Headquarters UK	Chippenham, England	1,900	November 30, 2010
Warehouse UK	Stafford, England	83,800	Half the space will expire on January 15, 2010, and the remaining half will expire on August 31, 2011
Warehouse UK	Milton Keynes, England	26,000	May 1, 2013

Our servers are housed in data centers in Ashburn, Virginia, which is managed by Equinix, Inc., in Phoenix, Arizona, which is managed by Limelight Networks, Inc., and in Atlanta, Georgia, which is managed by SunGard, LP.

**Item 3. 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 4. Submission of Matters to a Vote of Security Holders.**

No matters were submitted to a vote of security holders during the quarter ended September 30, 2009.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.****Price Range of Common Stock**

Our common stock has been traded on The NASDAQ Stock Market under the symbol LQDT since February 23, 2006. The following table sets forth the intra-day high and low per share bid price of our common stock as reported by The NASDAQ Stock Market for the periods indicated.

<b>Fiscal year ended September 30, 2008</b>	<b>Low</b>	<b>High</b>
First Quarter	\$ 9.99	\$ 15.18
Second Quarter	\$ 7.33	\$ 13.90
Third Quarter	\$ 7.80	\$ 13.00
Fourth Quarter	\$ 7.85	\$ 12.98
<b>Fiscal year ended September 30, 2009</b>		
First Quarter	\$ 5.10	\$ 10.74
Second Quarter	\$ 4.55	\$ 9.07
Third Quarter	\$ 6.85	\$ 10.96
Fourth Quarter	\$ 8.76	\$ 11.80

As of December 11, 2009, there were approximately 2,300 holders of record of our common stock.

**Dividend Policy**

Since becoming a public company on February 22, 2006, we have not paid cash dividends on our stock and currently anticipate that we will continue to retain any future earnings to finance the growth of our business.

Table of Contents**Item 6. Selected Financial Data.**

You should read the following selected consolidated financial data together with our consolidated financial statements and the related notes, and with "Management's Discussion and Analysis of Financial Condition and Results of Operations," included elsewhere in this Annual Report on Form 10-K. The consolidated statement of operations data for the years ended September 30, 2007, 2008 and 2009 are derived from, and are qualified by reference to, our consolidated financial statements that have been audited by Ernst & Young LLP, an independent registered public accounting firm, and that are included in this Annual Report on Form 10-K. The consolidated statement of operations data for the years ended September 30, 2005 and 2006, and the consolidated balance sheet data as of September 30, 2005, 2006 and 2007 are derived from our audited consolidated financial statements that are not included in this Annual Report on Form 10-K.

	Year ended September 30,				
	2005	2006	2007	2008	2009
	(dollars in thousands, except per share data)				
<b>Consolidated Statement of Operations Data:</b>					
Revenue	\$ 89,415	\$ 147,813	\$ 198,620	\$ 263,941	\$ 236,283
Costs and expenses:					
Cost of goods sold (excluding amortization)	6,288	12,160	47,043	71,303	86,591
Profit-sharing distributions	48,952	80,253	69,638	91,106	45,333
Technology and operations	14,696	20,081	33,417	41,512	46,479
Sales and marketing	5,503	8,861	13,203	16,997	18,253
General and administrative	7,397	12,073	16,901	21,523	22,534
Amortization of contract intangibles	135	813	813	813	813
Depreciation and amortization	586	727	1,302	2,083	3,116
Total costs and expenses	83,557	134,968	182,317	245,337	223,119
Income from operations	5,858	12,845	16,303	18,604	13,164
Interest (expense) income and other income, net	(570)	430	2,176	1,495	516
Income before provision for income taxes	5,288	13,275	18,479	20,099	13,680
Provision for income taxes	(1,166)	(5,294)	(7,460)	(8,546)	(7,961)
Net income	\$ 4,122	\$ 7,981	\$ 11,019	\$ 11,553	\$ 5,719
Basic earnings per common share	\$ 0.22	\$ 0.33	\$ 0.40	\$ 0.41	\$ 0.21
Basic weighted average shares outstanding	19,038,464	24,080,780	27,768,679	27,964,748	27,699,223
Diluted earnings per common share	\$ 0.18	\$ 0.31	\$ 0.39	\$ 0.41	\$ 0.21

Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

Diluted weighted average  
shares outstanding 22,598,519 26,087,809 28,146,923 28,151,878 27,846,693

**Non-GAAP Financial**

**Measures:**

EBITDA(1)	\$	6,579	\$	14,385	\$	18,418	\$	21,500	\$	17,093
Adjusted EBITDA(1)		6,666		15,008		20,361		26,174		23,558

**Supplemental Operating**

**Data:**

Gross merchandise volume(2)	\$	102,210	\$	173,090	\$	233,579	\$	359,673	\$	355,994
Completed transactions(3)		173,000		194,000		212,000		372,000		469,000
Total registered buyers(4)		386,000		524,000		685,000		999,000		1,202,000
Total auction participants(5)		848,000		993,000		1,115,000		1,751,000		2,118,000

31

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

	As of September 30,				
	2005	2006	2007	2008	2009
	(in thousands)				
<b>Consolidated Balance Sheet Data:</b>					
Cash, cash equivalents and short-term investments	\$ 10,378	\$ 66,648	\$ 61,609	\$ 63,198	\$ 64,154
Working capital(6)	4,154	54,082	61,762	51,044	59,795
Total assets	26,013	88,038	111,142	137,167	138,588
Total liabilities	14,596	22,286	29,108	40,797	34,606
Total stockholders' equity	10,943	65,752	82,034	96,370	103,982

- (1) EBITDA and adjusted EBITDA are supplemental non-GAAP financial measures. GAAP means generally accepted accounting principles in the United States. EBITDA is equal to net income plus (a) interest expense (income) and other income, net; (b) provision for income taxes; (c) amortization of contract intangibles; and (d) depreciation and amortization. Our definition of adjusted EBITDA is different from EBITDA because we further adjust EBITDA for stock based compensation expense. For a description of our use of EBITDA and adjusted EBITDA and a reconciliation of these non-GAAP financial measures to net income, see the discussion and related table below.
- (2) Gross merchandise volume is the total sales value of all merchandise sold through our marketplaces during a given period.
- (3) Completed transactions represent the number of auctions in a given period from which we have recorded revenue.
- (4) Total registered buyers as of a given date represent the aggregate number of persons or entities who have registered on one of our marketplaces.
- (5) For each auction we manage, the number of auction participants represents the total number of registered buyers who have bid one or more times on that auction, and total auction participants for a given period is the sum of the auction participants in each auction conducted during that period.
- (6) Working capital is defined as current assets minus current liabilities.

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 the 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 significantly fluctuated 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 substantial federal net operating loss carryforwards, or NOLs, we did not incur a standard income tax expense until fiscal 2006. With the exhaustion of our remaining federal NOLs during fiscal 2005, we recorded federal income tax expense for the first time, thus significantly decreasing our fiscal 2005 net income relative to prior years, however, the income tax recorded resulted in an effective tax rate of 22% for fiscal year 2005, compared to 40%, 43% and 58% for fiscal year 2007, 2008 and 2009, respectively. Consequently, 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.

During July 2001, we modified the exercise price of 3,402,794 stock options issued to employees. As a result, we are accounting for the modified stock options from the date of modification to the date the stock options are exercised, forfeited or expire unexercised using variable accounting. Under variable accounting, we revalue compensation costs for the stock

options at each reporting period based on changes in the intrinsic value of the stock options. We recorded

Table of Contents

approximately \$87,000, \$7,000 and \$1,000, respectively, in stock compensation expenses based on vesting of the fair value of the options for the years ended September 30, 2005, 2006 and 2007. We will continue to revalue compensation costs for the options based on changes in the fair value of our common stock in future periods. We believe that it is useful to exclude this expense because it results from a one-time event that requires us to record expense that we are not otherwise required to record in connection with new stock options granted during the same time period. In December 2004, the Financial Accounting Standards Board (FASB) issued new authoritative guidance with 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 provision 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. We recorded approximately \$616,000, \$1,942,000, \$4,674,000 and \$6,465,000, respectively, in stock compensation expenses based on the adoption of this new authoritative guidance for the years ended September 30, 2006, 2007, 2008 and 2009. As a result, we present a financial measure that adjusts net income and EBITDA for the stock compensation expense.

We believe EBITDA and adjusted EBITDA 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

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.

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

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

	<b>Year ended September 30,</b>				
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
	<b>(in thousands)</b>				
Net income	\$ 4,122	\$ 7,981	\$ 11,019	\$ 11,553	\$ 5,719
Interest expense (income) and other income, net	570	(430)	(2,176)	(1,495)	(516)
Provision for income taxes	1,166	5,294	7,460	8,546	7,961
Amortization of contract intangibles	135	813	813	813	813
Depreciation and amortization	586	727	1,302	2,083	3,116
EBITDA	6,579	14,385	18,418	21,500	17,093
Stock compensation expense	87	623	1,943	4,674	6,465
Adjusted EBITDA	\$ 6,666	\$ 15,008	\$ 20,361	\$ 26,174	\$ 23,558

Table of Contents

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*The following discussion should be read in conjunction with our consolidated financial statements and related notes and the information contained under the caption "Selected Consolidated Financial Data" contained elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could vary materially from those indicated, implied, or suggested by these forward-looking statements as a result of many factors, including those discussed under "Risk Factors" and elsewhere in this Annual Report on Form 10-K.*

**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, automated 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 digital images and other relevant product information. Additionally, we enable our 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. 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, and specialty equipment. Our online auction marketplaces are [www.liquidation.com](http://www.liquidation.com), [www.govliquidation.com](http://www.govliquidation.com), [www.govdeals.com](http://www.govdeals.com) and [www.liquibiz.com](http://www.liquibiz.com). We also operate a wholesale industry portal, [www.goWholesale.com](http://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 fiscal year 2009, the number of registered buyers grew from approximately 999,000 to approximately 1,202,000, or 20.3%. During the past three fiscal years, we have conducted over 1,052,000 online transactions generating approximately \$949 million in gross merchandise volume. Approximately 80% of our initial listings have resulted in a completed cash sale during the past three fiscal years.

*Our history.* We were incorporated in Delaware in November 1999 as Liquidation.com, Inc. and commenced operations in early 2000. During 2000, we developed our online auction marketplace platform and began auctioning merchandise primarily for small commercial sellers and government agencies. In 2001, we changed our name to Liquidity Services, Inc. In June 2001, we were awarded our first major DoD contract, the Surplus Contract. Under this agreement, we became the exclusive contractor with the DRMS, for the sale of usable DoD surplus assets in the United States. In June 2005, we were awarded an additional exclusive contract with the DRMS to manage and sell substantially all DoD scrap property. During 2004, we launched our wholesale industry portal, [www.goWholesale.com](http://www.goWholesale.com).

*Recent initiatives.* 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 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, thus we will receive 39.5% of the net proceeds on property received up until December 17, 2008 through the Contract wind down period, which we anticipate will extend into fiscal year 2010. We responded to a RFP from the DRMS regarding a renewal of the Surplus Contract, and have been awarded the contract. Under the new Surplus Contract, under which we commenced operations on December 18, 2008, we are not required to distribute any portion of the profits realized under the Contract, as the new Contract structure requires a fixed 3.26% price, of the DRMS' acquisition value, to be paid for the property and allows us to retain all of the profits from the sale of property. On February 4, 2009, the DoD agreed to amend the

Table of Contents

new Surplus Contract, such that the fixed 3.26% price, of the DRMS' acquisition value, to be paid for the property, will be 1.8%. In addition, the new Surplus Contract performance period will start from the time property was delivered during February 2009.

The current economic downturn has impacted the GMV in our commercial business both in the U.S. and the U.K. as retailers have reduced the volume of goods sold due to continued weak consumer spending. Our UK business suffered during the second half of fiscal year 2009, due to the loss of one of our major UK clients (client was sold), which led to a material decrease in volume. Progress is underway to replace this volume but we continue to expect our UK business to negatively impact earnings in the near term. We initiated cost savings initiatives in our UK business, including replacing some senior members of our operating team with managers having more operational and business development experience. At the same time, we have made the necessary technology, finance, and back office investments to support our UK business for long-term growth. These changes, will position our UK business to better serve our existing clients, and allow us to aggressively add new significant clients. We cannot predict, given the economic conditions, when we will realize these long-term benefits.

*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 61.5%, 62.4% and 40.7% of our total revenue for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. The merchandise sold under our profit-sharing model accounted for approximately 52.3%, 45.8% and 27.0% of our gross merchandise volume, or GMV, for the fiscal years ended September 30, 2007, 2008 and 2009, respectively.

*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 7.3%, 7.6% and 10.6% of our total revenue for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. The merchandise sold under our consignment model accounted for approximately 22.4%, 33.1% and 41.0% of our GMV for the fiscal years ended September 30, 2007, 2008 and 2009, respectively.

*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

Table of Contents

transaction. Revenue from our purchase model accounted for approximately 25.4%, 23.5% and 46.1% of our total revenue for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. The merchandise sold under our purchase model accounted for approximately 21.6%, 17.3% and 30.6% of our GMV, for the fiscal years ended September 30, 2007, 2008 and 2009, respectively.

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.

In fiscal years 2007, 2008 and 2009, we generated less than 2% of our revenue from advertisements on our wholesale industry portals.

*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 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 recent 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.

**Our Seller Agreements**

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

*Surplus Contract.* In June 2001, we were awarded the Surplus Contract, a competitive-bid exclusive contract under which we acquire, manage and sell all usable DoD surplus personal property turned into the DRMS. 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. Revenue from our Surplus Contract (including buyer premiums) accounted for approximately 33.9%, 31.3% and 32.8% of our total revenue for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. The property sold under our Surplus Contract accounted for approximately 28.8%, 23.0% and 21.8% of our GMV for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. On November 6, 2008, the DoD extended the original Surplus Contract through December 17, 2008, thus we will receive 39.5% of the net proceeds on property received up until December 17, 2008 through the Contract wind down period, which we anticipate will extend into fiscal year 2010. We responded to a RFP from the DRMS regarding a renewal of the Surplus Contract, and have been awarded the contract. We began operations under the new Contract on December 18, 2008. The new Surplus Contract expires in February 2012, subject to DoD's right to extend it for two additional one-year terms

*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 DRMS. Scrap property generally consists of items determined by DoD to have no use beyond their base material content, such as metals, alloys, and building materials. Revenue from our Scrap Contract (including buyer premiums) accounted for approximately 27.6%, 31.1% and 21.5% of our total revenue for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. The property sold under our Scrap Contract accounted for approximately 23.5%, 22.8% and

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

14.2% of our GMV for the fiscal years ended September 30, 2007, 2008 and 2009, respectively. 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 DoD's right to extend it for three additional one-year terms.

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 Contracts, and the DoD was entitled to approximately 80% of the profits. We refer to these disbursement payments to DoD as profit-sharing distributions. As a result of these arrangements, we recognize as revenue the gross proceeds from these sales. 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 September 12, 2006, we entered into a bilateral contract modification under which the DoD agreed to increase our profit-sharing percentage under the original Surplus Contract in exchange for our agreement to implement additional inventory assurance processes and procedures with respect to the sale of demilitarized property. Under the terms of the contract modification, from August 1, 2006 until November 30, 2006, we were entitled to receive 27.5% of the profits under the Surplus Contract and the DoD was entitled to receive 72.5%. For property received from November 30, 2006 through June 18, 2008, we were entitled to receive between 25% and 30.5% of the profits and thus the DoD received between 69.5% and 75% of the profits, based on the results of an audit of the effectiveness of the inventory controls we implemented under the contract modification, which is referred to as the Surplus Contract incentive. This incentive was measured quarterly. On June 1, 2007, we agreed, as provided in the modification to the original Surplus Contract that became effective as of September 12, 2006, to provide additional value-added services with respect to demilitarized property that is returned to the DoD for reutilization. In exchange for our agreement to provide these services, the DoD exercised its existing option to increase our share of net proceeds under the original Surplus Contract by 1%. 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 DRMS' 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 would allow 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 the 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.

*Our UK MoD agreement.* In July 2003, we were awarded a contract to manage and sell surplus property from the United Kingdom Ministry of Defence. This contract generated less than 4% of our revenue in fiscal years 2007, 2008 and 2009. This contract expires in July 2010.

*Our commercial agreements.* During fiscal year 2009, we had over 450 corporate clients who each sold in excess of \$10,000 of surplus and salvage assets in our marketplaces. Our agreements with these clients are generally terminable at will by either party.

Table of Contents

**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:

*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 marketplace during fiscal year 2009 totaled \$356.0 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 fiscal year ended September 30, 2009, we completed approximately 469,000 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 September 30, 2009, we had approximately 1,202,000 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 fiscal year ended September 30, 2009, approximately 2,118,000 total auction participants participated in auctions on our marketplaces.

Table of Contents

**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.* We recognize revenue in accordance with the provisions of Staff Accounting Bulletin No. 104, *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;
- for arrangements with an inspection period, the buyer has received the merchandise and has not notified us within that period that it is dissatisfied with the merchandise; and
- collection is reasonably assured.

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. 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.

The buyer does not and cannot look to the supplier for fulfillment or for product acceptability concerns.



Table of Contents

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.

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 \$37.9 million at September 30, 2009. 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.

Table of Contents

We adopted the provisions of authoritative guidance issued by the FASB related to accounting for uncertainty in income taxes on October 1, 2007. The adoption of this new authoritative guidance did not impact the Company's financial position or results of operations. The Company has 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.

*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. 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 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.

Table of Contents

*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.

*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 income, 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.

*Income taxes.* During fiscal years 2007, 2008 and 2009, we had an effective income tax rate of approximately 40%, 43% and 58%, 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. 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.

Table of Contents**Results of Operations**

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

	Year ended September 30,		
	2007	2008	2009
Revenue	100.0%	100.0%	100.0%
Costs and expenses:			
Cost of goods sold (excluding amortization)	23.7	27.0	36.6
Profit-sharing distributions	35.1	34.5	19.2
Technology and operations	16.8	15.7	19.7
Sales and marketing	6.6	6.5	7.7
General and administrative	8.5	8.2	9.5
Amortization of contract intangibles	0.4	0.3	0.3
Depreciation and amortization	0.7	0.8	1.4
Total costs and expenses	91.8	93.0	94.4
Income from operations	8.2	7.0	5.6
Interest income and other income, net	1.1	0.6	0.2
Income before provision for income taxes	9.3	7.6	5.8
Provision for income taxes	(3.8)	(3.2)	(3.4)
Net income	5.5%	4.4%	2.4%

***Year Ended September 30, 2009 Compared to Year Ended September 30, 2008***

**Revenue.** Revenue decreased \$27.6 million, or 10.5%, to \$236.3 million for the year ended September 30, 2009 from \$263.9 million for the year ended September 30, 2008. This decrease was primarily due to a 37.6% decrease in our scrap business, which utilizes the profit sharing model, as a result of decreasing commodity prices. This business generated 21.5% of our revenue and 14.2% of our GMV for the fiscal year ended September 30, 2009, as compared to 31.1% and 22.8%, respectively, for the fiscal year ended September 30, 2008. The amount of GMV transacted through our marketplaces decreased \$3.7 million, or 1.0%, to \$356.0 million for the year ended September 30, 2009 from \$359.7 million for the year ended September 30, 2008. This decrease was not as significant as our revenue decrease as our consignment model, which generated 10.6% of our revenue and 41.0% of our GMV for the fiscal year ended September 30, 2009, as compared to 33.1% and 7.6%, respectively, for the fiscal year ended September 30, 2008, grew 22.6%.

**Cost of goods sold (excluding amortization).** Cost of goods sold (excluding amortization) increased \$15.3 million, or 21.4%, to \$86.6 million for the year ended September 30, 2009 from \$71.3 million for the year ended September 30, 2008. As a percentage of revenue, cost of goods sold (excluding amortization) increased to 36.6% in fiscal 2009 compared to 27.0% in fiscal 2008. These increases are primarily due to (1) expenses of \$5.7 million associated with a full year of Geneva, which was acquired on May 1, 2008 and utilizes the purchase model, which has a higher cost of goods sold than the profit sharing model; (2) expenses of \$10.4 million associated with the new Surplus Contract which began sales during March 2009 and also utilizes the purchase model; and (3) the 37.6% decrease in our scrap business revenue, which utilizes the profit sharing model.

**Profit-sharing distributions.** Profit-sharing distributions decreased \$45.8 million, or 50.2%, to \$45.3 million for the year ended September 30, 2009 from \$91.1 million for the year ended September 30, 2008. As a percentage of revenue, profit-sharing distributions decreased to 19.2% in

Table of Contents

fiscal 2009 from 34.5% in fiscal 2008. These decreases are primarily due to (1) a 37.6% decrease in our scrap business and (2) the new Surplus Contract, which has no provision for distributions.

*Technology and operations expenses.* Technology and operations expenses increased \$5.0 million, or 12.0%, to \$46.5 million for the year ended September 30, 2009 from \$41.5 million for the year ended September 30, 2008. As a percentage of revenue, these expenses increased to 19.7% in fiscal 2009 from 15.7% in fiscal 2008. These increases are primarily due to (1) the decrease of 37.6% in revenue from our scrap business, while incurring similar operational costs as pounds of scrap sold during the two periods were not materially different; (2) expenses of \$0.8 million associated with the roll out of operations under our new Surplus Contract; (3) expenses of \$3.0 million associated with our commercial business; and (4) expenses of \$1.2 million associated with a full year of Geneva, which was acquired on May 1, 2008.

*Sales and marketing expenses.* Sales and marketing expenses increased \$1.3 million, or 7.4%, to \$18.3 million for the year ended September 30, 2009 from \$17.0 million for the year ended September 30, 2008. As a percentage of revenue, these expenses increased to 7.7% in fiscal 2009 from 6.5% in fiscal 2008. These increases are primarily due to our hiring of 13 additional sales and marketing employees.

*General and administrative expenses.* General and administrative expenses increased \$1.0 million, or 4.7%, to \$22.5 million for the year ended September 30, 2009 from \$21.5 million for the year ended September 30, 2008. As a percentage of revenue, these expenses increased to 9.5% in fiscal 2009 from 8.2% in fiscal 2008. These increases are primarily due to (1) the decrease of 37.6% in revenue from our scrap business, which incurred similar costs during fiscal 2009 and 2008; and (2) expenses of \$1.0 million related to stock-based compensation.

*Amortization of contract intangibles.* Amortization of contract intangibles was consistent at \$0.8 million for the year ended September 30, 2009 and 2008, as a result 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, which began in August 2005.

*Depreciation and amortization expenses.* Depreciation and amortization expenses increased \$1.0 million, or 49.6%, to \$3.1 million for the year ended September 30, 2009 from \$2.1 million for the year ended September 30, 2008, primarily due to additional depreciation expense resulting from the purchase of \$3.7 million of property and equipment during fiscal year ended September 30, 2009 compared to the purchase of \$1.7 million of property and equipment during fiscal year ended September 30, 2008.

*Interest income and other income, net.* Interest income and other income, net decreased \$1.0 million, or 65.5%, to \$0.5 million for the year ended September 30, 2009 from \$1.5 million for the year ended September 30, 2008, primarily due to a reduction in short term interest rates.

*Provision for income tax expense.* Income tax expense decreased \$0.6 million, or 6.8%, to \$8.0 million for the year ended September 30, 2009 from \$8.5 million for the year ended September 30, 2008, primarily due to the decrease in income before provision for income taxes. The fiscal year 2009 effective income tax rate increased to 58.2% from 42.5% in fiscal year 2008. 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. 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.

Table of Contents

*Net income.* Net income decreased \$5.9 million, or 50.5%, to \$5.7 million for the year ended September 30, 2009 from \$11.6 million for the year ended September 30, 2008.

*Year Ended September 30, 2008 Compared to Year Ended September 30, 2007*

*Revenue.* Revenue increased \$65.3 million, or 32.9%, to \$263.9 million for the year ended September 30, 2008 from \$198.6 million for the year ended September 30, 2007. This increase was primarily due to a 75.8% increase in the number of completed transactions through our online auction marketplaces, to approximately 372,000 for the year ended September 30, 2008 from 212,000 for the year ended September 30, 2007. The amount of GMV transacted through our marketplaces increased \$126.1 million, or 54.0%, to \$359.7 million for the year ended September 30, 2008 from \$233.6 million for the year ended September 30, 2007. We believe this increase is attributable to (1) our investment in our sales and marketing organization, as well as increased market acceptance by corporate sellers and professional buyers of our online marketplaces as an efficient channel to auction and purchase surplus and salvage assets, which resulted in 22.9% growth in our commercial market place over the same period last year; (2) our Scrap Contract, which generated 31.1% of our revenue and 22.8% of our GMV for the fiscal year ended September 30, 2008, grew 48.3% from fiscal year ended September 30, 2007; (3) our Surplus Contract, which generated 31.3% of our revenue and 23.0% of our GMV for the fiscal year ended September 30, 2008, grew 23.5% from fiscal year ended September 30, 2007; (4) the acquisition of GovDeals, completed on January 1, 2008, which generated 1.5% of our revenue and 15.2% of our GMV for the fiscal year ended September 30, 2008; and (5) the acquisition of Geneva, completed on May 1, 2008, which generated 2.7% of our revenue and 2.0% of our GMV for the fiscal year ended September 30, 2008. We also benefited from our ability to more effectively market assets to potential buyers as we gained transaction experience and industry knowledge in the vertical product segments auctioned through our marketplaces. Our marketing efforts and acquisitions resulted in an approximate 46.0% increase in registered buyers to approximately 999,000 at September 30, 2008 from approximately 685,000 at September 30, 2007.

*Cost of goods sold (excluding amortization).* Cost of goods sold (excluding amortization) increased \$24.3 million, or 51.6%, to \$71.3 million for the year ended September 30, 2008 from \$47.0 million for the year ended September 30, 2007. As a percentage of revenue, cost of goods sold (excluding amortization) increased to 27.0% in fiscal 2008 compared to 23.7% in fiscal 2007. These increases are primarily due to (1) an increase in the volume of goods sold by existing sellers utilizing our purchase model; (2) a mix shift to apparel items, which realized a lower margin during fiscal year 2008; and (3) the acquisition of Geneva, which was completed on May 1, 2008, which utilizes the purchase model.

*Profit-sharing distributions.* Profit-sharing distributions increased \$21.5 million, or 30.8%, to \$91.1 million for the year ended September 30, 2008 from \$69.6 million for the year ended September 30, 2007, primarily due to 23.5% growth in our surplus business and 48.3% growth in our scrap business. As a percentage of revenue, profit-sharing distributions decreased to 34.5% in fiscal 2008 from 35.1% in fiscal 2007, primarily due to a decrease in the amount of profits we are required to pay the DoD under our Surplus Contract, which was modified on September 12, 2006 and May 13, 2008, as well as the Scrap Contract, which was modified on June 1, 2007. A detailed discussion of the Surplus and Scrap Contract modifications can be found above under "Our Seller Agreements."

*Technology and operations expenses.* Technology and operations expenses increased \$8.1 million, or 24.2%, to \$41.5 million for the year ended September 30, 2008 from \$33.4 million for the year ended September 30, 2007, primarily due to (1) the addition of 50 technology and operations personnel, the majority of whom were needed to support the increased volume of transactions and merchandise discussed above; (2) the acquisition of GovDeals, which was completed on January 1, 2008; and (3) the acquisition of Geneva, which was completed on May 1, 2008. As a percentage of revenue, these

Table of Contents

expenses decreased to 15.7% in fiscal 2008 from 16.8% in fiscal 2007, primarily due to our growth in revenue, while leveraging our fixed expenses, such as programming personnel.

*Sales and marketing expenses.* Sales and marketing expenses increased \$3.8 million, or 28.7%, to \$17.0 million for the year ended September 30, 2008 from \$13.2 million for the year ended September 30, 2007, primarily due to the hiring of 29 additional sales and marketing personnel and \$1.5 million in increased expenditures on marketing and promotional activities across our marketplaces. As a percentage of revenue, these expenses were consistent at 6.5% in fiscal 2008 and 6.6% in fiscal 2007.

*General and administrative expenses.* General and administrative expenses increased \$4.6 million, or 27.3%, to \$21.5 million for the year ended September 30, 2008 from \$16.9 million for the year ended September 30, 2007, primarily due to (1) costs of \$0.8 million related to additional accounting, legal, insurance, compliance and other expenses needed to support our growth; (2) expenses of \$0.9 million related to Statement 123(R); (3) costs of \$0.2 million for travel related expenses associated with business development efforts; (4) expenses of \$0.7 million associated with GovDeals, which was acquired on January 1, 2008; and (5) expenses of \$0.8 million associated with Geneva, which was acquired on May 1, 2008. As a percentage of revenue, these expenses decreased to 8.2% in fiscal 2008 from 8.5% in fiscal 2007, primarily due to our growth in revenue, while leveraging our fixed expenses, such as corporate staff.

*Amortization of contract intangibles.* Amortization of contract intangibles was consistent at \$0.8 million for the year ended September 30, 2008 and 2007, as a result 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, which began in August 2005.

*Depreciation and amortization expenses.* Depreciation and amortization expenses increased \$0.8 million, or 59.9%, to \$2.1 million for the year ended September 30, 2008 from \$1.3 million for the year ended September 30, 2007, primarily due to additional depreciation expense resulting from the purchase of \$2.7 million of property and equipment during fiscal year ended September 30, 2007.

*Interest income and other income, net.* Interest income and other income, net decreased \$0.7 million, or 31.3%, to \$1.5 million for the year ended September 30, 2008 from \$2.2 million for the year ended September 30, 2007, primarily due to (1) a reduction in the cash balance during most of fiscal year 2008 due to the recent GovDeals and Geneva acquisitions and (2) a reduction in short term interest rates.

*Provision for income tax expense.* Income tax expense increased \$1.0 million, or 14.6%, to \$8.5 million for the year ended September 30, 2008 from \$7.5 million for the year ended September 30, 2007, primarily due to the increase in income before provision for income taxes.

*Net income.* Net income increased \$0.6 million, or 4.8%, to \$11.6 million for the year ended September 30, 2008 from \$11.0 million for the year ended September 30, 2007.

**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 September 30, 2009, we had approximately \$33.5 million in cash and cash equivalents, \$30.6 million in short-term investments and \$21.4 million available under our \$30.0 million senior credit facility.

On December 2, 2008, our Board of Directors approved a stock repurchase program. Under the program, we are authorized to repurchase up to \$10 million of our issued and outstanding shares of

Table of Contents

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. Our Board of Directors reviews the share repurchase program periodically. During the three months ended March 31, 2009, 707,462 shares were purchased under the program for approximately \$3.9 million. There have been no subsequent share repurchases. As of September 30, 2009, approximately \$6.1 million 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: 2009 Compared to 2008***

Net cash provided by operating activities decreased \$20.4 million to \$8.6 million for the year ended September 30, 2009 from \$29.0 million for the year ended September 30, 2008. For the year ended September 30, 2009, net cash provided by operating activities primarily consisted of net income of \$5.7 million, depreciation and amortization expense of \$3.9 million, stock compensation expense of \$6.5 million, provision for doubtful accounts of \$0.1, offset in part by a net decrease in accounts payable, accrued expenses and other liabilities of \$6.1 million and deferred tax benefit of \$1.5 million. For the year ended September 30, 2008, net cash provided by operating activities primarily consisted of net income of \$11.5 million, depreciation and amortization expense of \$2.9 million, stock compensation expense of \$4.7 million, a net decrease in accounts receivable, inventory and prepaid expenses and other assets of \$6.3 million and a net increase in accounts payable, accrued expenses and other liabilities of \$5.6 million, offset in part by provision for doubtful accounts of \$0.7 million and deferred tax benefit of \$1.3 million.

Net cash used in investing activities was \$24.0 million for the year ended September 30, 2009 and \$17.1 million for the year ended September 30, 2008. Net cash used in investing activities in fiscal 2009 consisted primarily of capital expenditures of \$3.7 million, \$0.9 million for the purchase of the assets of a company and net purchases of short-term investments of \$19.4 million. Net cash used in investing activities in fiscal 2008 consisted primarily of capital expenditures of \$1.7 million and \$25.6 million for the purchase of GovDeals and the Geneva Group, offset in part by net proceeds from the sale of short-term investments of \$10.2 million.

Net cash used in financing activities was \$2.7 million for the year ended September 30, 2009 and net cash provided by financing activities was \$0.4 million for the year ended September 30, 2008. Net cash used in financing activities in fiscal 2009 consisted primarily of \$3.9 million for stock repurchases, offset in part by proceeds from the exercise of common stock options including the tax benefit of \$1.2 million. Net cash provided by financing activities in fiscal 2008 consisted primarily of \$0.5 million from the sale of common stock issued upon stock option exercises, offset by the net repayment of debt and capital leases of \$0.1 million.

***Changes in Cash Flows: 2008 Compared to 2007***

Net cash provided by operating activities increased \$24.5 million to \$29.0 million for the year ended September 30, 2008 from \$4.5 million for the year ended September 30, 2007. For the year ended September 30, 2008, net cash provided by operating activities primarily consisted of net income of \$11.5 million, depreciation and amortization expense of \$2.9 million, stock compensation expense of \$4.7 million, a net decrease in accounts receivable, inventory and prepaid expenses and other assets of

Table of Contents

\$6.3 million and a net increase in accounts payable, accrued expenses and other liabilities of \$5.6 million, offset in part by provision for doubtful accounts of \$0.7 million and deferred tax benefit of \$1.3 million. For the year ended September 30, 2007, net cash provided by operating activities primarily consisted of net income of \$11.0 million, depreciation and amortization expense of \$2.1 million, stock compensation expense of \$1.9 million, other adjustments of \$0.3 million, and a net increase in accounts payable, accrued expenses and other liabilities of \$8.4 million, offset in part by an increase in accounts receivable, inventory and prepaid expenses and other assets of \$16.9 million and deferred tax benefit of \$2.3 million.

Net cash used in investing activities was \$17.1 million for the year ended September 30, 2008 and \$22.0 million for the year ended September 30, 2007. Net cash used in investing activities in fiscal 2008 consisted primarily of capital expenditures of \$1.7 million and \$25.6 million for the purchase of GovDeals and the Geneva Group, offset in part by net proceeds from the sale of short-term investments of \$10.2 million. Net cash used in investing activities in fiscal 2007 consisted primarily of net purchases of short-term investments of \$9.2 million, capital expenditures of \$2.7 million, \$9.9 million for the purchase of STR and \$0.2 million for intangible assets.

Net cash provided by financing activities was \$0.4 million for the year ended September 30, 2008 and \$2.8 million for the year ended September 30, 2007. Net cash provided by financing activities in fiscal 2008 consisted primarily of \$0.5 million from the sale of common stock issued upon stock option exercises, offset by the net repayment of debt and capital leases of \$0.1 million. Net cash provided by financing activities in fiscal 2007 consisted primarily of net proceeds from the follow-on public stock offering of \$1.1 million and \$1.8 million from the sale of common stock issued upon stock option exercises, offset by the net repayment of debt and capital leases 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 \$3.0 million to \$3.5 million in the fiscal year ending September 30, 2010. We intend to fund those expenditures primarily from operating cash flows. Our capital expenditures for the year ended September 30, 2009 were \$3.7 million. As of September 30, 2009, we had no outstanding commitments for capital expenditures.

*Senior credit facility.* We maintain a \$30.0 million senior credit facility due March 31, 2010. We are in discussions with the lender to extend the credit facility, but there is no assurance that we will be able to do so. The senior credit facility bears an annual interest rate of 30 day LIBOR plus 1.5%. As of September 30, 2009, we had no outstanding indebtedness under our senior credit facility and our borrowing availability was \$21.4 million due to issued Letters of Credit for \$8.6 million; \$1.0 million of our current availability under this facility is set aside as a contractual obligation under our Scrap Contract operations. 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 subsidiaries organized to service our DoD contracts) 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. 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 September 30, 2009, 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

Table of Contents

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.

**Contractual and Commercial Commitments**

The table below represents our significant commercial commitments as of September 30, 2009. Capital leases are reflected on our September 30, 2009 balance sheet. Operating leases, which represent commitments to rent office and warehouse space in the United States and Europe, are not reflected on our balance sheets.

	Total	Less than 1 year	1 to 3 years	3 to 5 Years	5+ years
	(in thousands)				
Operating leases	\$ 17,326	\$ 6,513	\$ 8,952	\$ 1,861	
Capital leases	139	57	82		
Total contractual cash obligations	\$ 17,465	\$ 6,570	\$ 9,034	\$ 1,861	

**Off-Balance Sheet Arrangements**

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

**Inflation**

Inflation generally affects us by increasing our cost of labor and equipment. We do not believe that inflation had any material effect on our results of operations during the fiscal years ended September 30, 2007, 2008 and 2009.

**New Accounting Pronouncements**

In December 2007, the FASB issued new authoritative guidance related to business combinations. This statement changes the accounting for acquisitions specifically eliminating the step acquisition model, changing the recognition of contingent consideration from being recognized when it is probable to being recognized at the time of acquisition, disallowing the capitalization of transaction costs and delays when restructurings related to acquisitions can be recognized. We will adopt this statement for fiscal year beginning October 1, 2009 and it will only impact the accounting for acquisitions we make after its adoption, except for the amendment related to income taxes, which will be applied prospectively as of the adoption date and will apply to business combinations with acquisition dates before the effective date of this new authoritative guidance.

Table of Contents

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

*Interest rate sensitivity.* We did not have any debt as of September 30, 2009 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 September 30, 2009, 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 six percent of our sales are denominated in foreign currencies. We have not engaged in any hedging or other derivative transactions to date.

**Item 8. Financial Statements and Supplemental Data.**

Annual Financial Statements and Selected Financial Data: The consolidated financial statements and accompanying notes listed in Part IV, Item 15(a)(1) of this Annual Report on Form 10-K are included elsewhere in this Annual Report.

**Item 9. Changes in and Disagreement with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

Attached as exhibits to this Form 10-K are certifications of our Chief Executive Officer and Chief Financial Officer, which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended. This "Controls and Procedures" section includes information concerning the controls and controls evaluation referred to in the certifications. The report of Ernst & Young LLP, our independent registered public accounting firm, regarding management's assessment of internal control over financial reporting, and its audit of our internal control over financial reporting is set forth below in this section. This section should be read in conjunction with the certifications and the Ernst & Young LLP report for a more complete understanding of the topics presented.

**Evaluation of Disclosure Controls and Procedures**

We conducted an evaluation of the effectiveness of the design and operation of our "disclosure controls and procedures" as of the end of the period covered by this Form 10-K. The controls evaluation was conducted under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. Disclosure controls are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, such as this Form 10-K, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Our quarterly evaluation of disclosure controls includes an evaluation of some components of our internal control over financial reporting, and internal control

Table of Contents

over financial reporting is also separately evaluated on an annual basis for purposes of providing the management report which is set forth below.

The evaluation of our disclosure controls included a review of the controls' objectives and design, our implementation of the controls and their effect on the information generated for use in this Form 10-K. In the course of the controls evaluation, we reviewed identified data errors, control problems or indications of potential fraud and, where appropriate, sought to confirm that appropriate corrective actions, including process improvements, were being undertaken. This type of evaluation is performed on a quarterly basis so that the conclusions of management, including the Chief Executive Officer and Chief Financial Officer, concerning the effectiveness of the disclosure controls can be reported in our periodic reports on Form 10-Q and Form 10-K. Many of the components of our disclosure controls are also evaluated on an ongoing basis by our finance organization. The overall goals of these various evaluation activities are to monitor our disclosure controls, and to modify them as necessary. Our intent is to maintain the disclosure controls as dynamic systems that change as conditions warrant.

Based upon the controls evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this Form 10-K, our disclosure controls were effective to provide reasonable assurance that information required to be disclosed in our Securities Exchange Act reports is recorded, processed, summarized and reported within the time periods specified by the SEC, and that material information related to Liquidity Services and our consolidated subsidiaries is made known to management, including the Chief Executive Officer and Chief Financial Officer, particularly during the period when our periodic reports are being prepared. We reviewed the results of management's evaluation with the Audit Committee of our Board of Directors.

**Management Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining effective internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles; and (iii) provide reasonable assurance regarding authorization to effect the acquisition, use or disposition of company assets, as well as the prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Management assessed our internal control over financial reporting as of September 30, 2009, the end of our fiscal year. Management based its assessment on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management's assessment included evaluation of such elements as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies and our overall control environment. This assessment is supported by testing and monitoring performed by our finance organization.

Based on this assessment, management has concluded that our internal control over financial reporting was effective as of the end of the fiscal year to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

Table of Contents

Our independent registered public accounting firm, Ernst & Young LLP, independently assessed the effectiveness of the company's internal control over financial reporting. Ernst & Young has issued an attestation report, which is included at the end of this section.

**Inherent Limitations on Effectiveness of Controls**

A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Other inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

**Changes in Internal Control over Financial Reporting**

On a quarterly basis we evaluate any changes to our internal control over financial reporting to determine if material changes occurred. There were no changes in our internal controls over financial reporting during the quarterly period ended September 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Board of Directors and Stockholders of  
Liquidity Services, Inc. and Subsidiaries

We have audited Liquidity Services, Inc.'s internal control over financial reporting as of September 30, 2009, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Liquidity Services, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Liquidity Services, Inc. maintained, in all material respects, effective internal control over financial reporting as of September 30, 2009, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Liquidity Services, Inc. and subsidiaries as of September 30, 2009 and 2008, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended September 30, 2009 of Liquidity Services, Inc. and subsidiaries and our report dated December 11, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

McLean, Virginia  
December 11, 2009

**Item 9B. Other Information.**

None.

Table of Contents

**PART III**

**Item 10. Directors and Executive Officers of the Registrant.**

Incorporated by reference from the Company's Proxy Statement relating to its 2010 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 30, 2009.

**Code of Ethics, Governance Guidelines and Committee Charters**

We have adopted a *Code of Business Conduct and Ethics* that applies to all Liquidity Services employees. We have also adopted a *Code of Ethics for Senior Officers* that applies to our senior officers, including our principal executive officer, principal financial officer and principal accounting officer. The *Code of Ethics for Senior Officers* is available on our website.

**Item 11. Executive Compensation.**

Incorporated by reference from the Company's Proxy Statement relating to its 2010 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 30, 2009.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholders Matters.**

Incorporated by reference from the Company's Proxy Statement relating to its 2010 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 30, 2009.

**Item 13. Certain Relationship and Related Transactions.**

Incorporated by reference from the Company's Proxy Statement relating to its 2010 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 30, 2009.

**Item 14. Principal Accountant Fees and Services.**

Incorporated by reference from the Company's Proxy Statement relating to its 2010 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 30, 2009.

Table of Contents

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules.**

	<b>Page</b>
(a)(1) The following financial statements are filed as part of this report: Report of Independent Registered Public Accounting Firm	57
Financial Statements covered by the Report of Independent Registered Public Accounting Firm: Consolidated Balance Sheets as of September 30, 2008 and 2009	58
Consolidated Statements of Operations for the years ended September 30, 2007, 2008 and 2009	59
Consolidated Statements of Changes in Stockholders' Equity for the years ended September 30, 2007, 2008 and 2009	60
Consolidated Statements of Cash Flows for the years ended September 30, 2007, 2008 and 2009	61
Notes to the Consolidated Financial Statements	62
(a)(2) The following financial statement schedule is filed as part of this report: Schedule for the three years ended September 30, 2007, 2008 and 2009: II Valuation and Qualifying Accounts	79
All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required or are inapplicable and therefore have been omitted.	
(a)(3) The documents required to be filed as exhibits to this report under Item 601 of Regulation S-K are listed in the Exhibit Index included elsewhere in this report, which list is incorporated herein by reference.	

Table of Contents

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders of  
Liquidity Services, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Liquidity Services, Inc. and subsidiaries as of September 30, 2009 and 2008, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended September 30, 2009. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Liquidity Services, Inc. and subsidiaries at September 30, 2009 and 2008, and the consolidated results of their operations and their cash flows for each of the three years in the period ended September 30, 2009, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Liquidity Services, Inc.'s internal control over financial reporting as of September 30, 2009, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated December 11, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

McLean, Virginia  
December 11, 2009

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**  
**Consolidated Balance Sheets**  
**(Dollars in Thousands)**

	September 30,	
	2009	2008
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 33,538	\$ 51,954
Short-term investments	30,616	11,244
Accounts receivable, net of allowance for doubtful accounts of \$613 and \$519 in 2009 and 2008, respectively	4,243	4,658
Inventory	14,280	13,327
Prepaid expenses, deferred taxes and other current assets	8,705	7,653
<b>Total current assets</b>	<b>91,382</b>	<b>88,836</b>
Property and equipment, net	6,147	4,730
Intangible assets, net	4,203	5,561
Goodwill	33,738	34,696
Other assets	3,118	3,344
<b>Total assets</b>	<b>\$ 138,588</b>	<b>\$ 137,167</b>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 5,456	\$ 8,303
Accrued expenses and other current liabilities	14,740	10,314
Profit-sharing distributions payable	4,538	10,312
Customer payables	6,797	8,841
Current portion of capital lease obligations	56	22
<b>Total current liabilities</b>	<b>31,587</b>	<b>37,792</b>
Capital lease obligations, net of current portion	82	44
Deferred taxes and other long-term liabilities	2,937	2,961
<b>Total liabilities</b>	<b>34,606</b>	<b>40,797</b>
Stockholders' equity:		
Common stock, \$0.001 par value; 120,000,000 shares authorized; 28,271,983 shares issued and 27,564,521 shares outstanding at September 30, 2009; 28,023,361 shares issued and outstanding at September 30, 2008	28	28
Additional paid-in capital	73,641	65,973
Treasury stock, at cost	(3,874)	(1,717)
	(3,618)	(1,717)

Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

Accumulated other comprehensive loss		
Retained earnings	37,805	32,086
Total stockholders' equity	103,982	96,370

Total liabilities and stockholders' equity \$ 138,588 \$ 137,167

*See accompanying notes to the consolidated financial statements.*

Table of Contents

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

	Year ended September 30,		
	2009	2008	2007
Revenue	\$ 236,283	\$ 263,941	\$ 198,620
Costs and expenses:			
Cost of goods sold (excluding amortization)	86,591	71,303	47,043
Profit-sharing distributions	45,333	91,106	69,638
Technology and operations	46,479	41,512	33,417
Sales and marketing	18,253	16,997	13,203
General and administrative	22,534	21,523	16,901
Amortization of contract intangibles	813	813	813
Depreciation and amortization	3,116	2,083	1,302
Total costs and expenses	223,119	245,337	182,317
Income from operations	13,164	18,604	16,303
Interest income and other income, net	516	1,495	2,176
Income before provision for income taxes	13,680	20,099	18,479
Provision for income taxes	(7,961)	(8,546)	(7,460)
Net income	\$ 5,719	\$ 11,553	\$ 11,019
Basic earnings per common share	\$ 0.21	\$ 0.41	\$ 0.40
Diluted earnings per common share	\$ 0.21	\$ 0.41	\$ 0.39
Basic weighted average shares outstanding	27,699,223	27,964,748	27,768,679
Diluted weighted average shares outstanding	27,846,693	28,151,878	28,146,923

*See accompanying notes to the consolidated financial statements.*

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**  
**Consolidated Statements of Changes in Stockholders' Equity**  
(In Thousands Except Share Data)

	Treasury Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive	Retained Earnings	Total
	Shares	Amount	Shares	Amount		Income (Loss)		
Balance at September 30, 2006			27,584,608	\$ 27	\$ 55,964	\$ 247	\$ 9,514	\$ 65,752
Follow-on public offering			100,000		1,070			1,070
Exercise of common stock options			254,451	1	1,843			1,844
Compensation expense from grant of common stock options					1,943			1,943
Comprehensive income:								
Net income							11,019	11,019
Foreign currency translation and other						406		406
Balance at September 30, 2007			27,939,059	28	60,820	653	20,533	82,034
Exercise of common stock options			84,302		345			345
Compensation expense from grant of common stock options					4,808			4,808
Comprehensive income:								
Net income							11,553	11,553
Foreign currency translation and other						(2,370)		(2,370)
Balance at September 30, 2008			28,023,361	28	65,973	(1,717)	32,086	96,370
Common stock repurchase	(707,462)	\$ (3,874)						(3,874)
Exercise of common stock options and restricted stock			248,622		1,082			1,082
Compensation expense from grant of common stock options					6,586			6,586
Comprehensive income:								
Net income							5,719	5,719
Foreign currency translation and other						(1,901)		(1,901)
Balance at September 30, 2009	(707,462)	\$ (3,874)	28,271,983	\$ 28	\$ 73,641	\$ (3,618)	\$ 37,805	\$ 103,982

*See accompanying notes to the consolidated financial statements.*

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
(In Thousands)

	2009	2008	2007
<b>Operating activities</b>			
Net income	\$ 5,719	\$ 11,553	\$ 11,019
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,929	2,895	2,115
Stock compensation expense	6,465	4,674	1,943
Provision (benefit) for doubtful accounts	93	(736)	171
Deferred tax benefit	(1,534)	(1,305)	(2,296)
Loss on disposal of property and equipment			85
Changes in operating assets and liabilities:			
Accounts receivable	356	2,107	(3,087)
Inventory	(801)	4,615	(9,986)
Prepaid expenses and other assets	475	(405)	(3,849)
Accounts payable	(2,848)	2,602	1,260
Accrued expenses and other	4,427	(2,030)	4,984
Profit-sharing distributions payable	(5,773)	3,393	(816)
Customer payables	(2,088)	2,512	(405)
Other liabilities	215	(884)	3,336
Net cash provided by operating activities	8,635	28,991	4,474
<b>Investing activities</b>			
Purchases of short-term investments	(35,113)	(36,180)	(36,099)
Proceeds from the sale of short-term investments	15,737	46,400	26,809
Increase in goodwill and intangibles and cash paid for acquisitions	(954)	(25,664)	(10,064)
Purchases of property and equipment	(3,681)	(1,669)	(2,688)
Net cash used in investing activities	(24,011)	(17,113)	(22,042)
<b>Financing activities</b>			
Proceeds from issuance of debt			10
Proceeds from the issuance of common stock			1,070
Principal repayments of capital lease obligations and debt	(27)	(51)	(81)
Repurchases of common stock	(3,874)		
Proceeds from exercise of common stock options (net of tax)	1,081	345	1,037
Incremental tax benefit from exercise of common stock options	121	133	807
Net cash (used in) provided by financing activities	(2,699)	427	2,843
Effect of exchange rate differences on cash and cash equivalents	(341)	(305)	320
Net (decrease) increase in cash and cash equivalents	(18,416)	12,000	(14,405)
Cash and cash equivalents at beginning of year	51,954	39,954	54,359

Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

Cash and cash equivalents at end of year       \$ 33,538   \$ 51,954   \$ 39,954

**Supplemental disclosure of cash flow information**

Property and equipment acquired through capital leases	\$ 100	\$ 65	\$ 10
Cash paid for income taxes	9,251	11,656	7,901
Cash paid for interest	44	23	5

*See accompanying notes to the consolidated financial statements.*

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to 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, and specialty equipment. The Company's online auction marketplaces are [www.liquidation.com](http://www.liquidation.com), [www.govliquidation.com](http://www.govliquidation.com), [www.govdeals.com](http://www.govdeals.com) and [www.liquibiz.com](http://www.liquibiz.com). LSI also operates a wholesale industry portal, [www.goWholesale.com](http://www.goWholesale.com) that connects advertisers with buyers seeking products for resale and related business services.

The Company's operations are subject to certain risks and uncertainties associated with technology-oriented companies including, but not limited to, the Company's dependence on use of the Internet, the effect of general business and economic trends, its susceptibility to rapid technological change, actual and potential competition by entities with greater financial resources, and the potential for the U.S. Government agencies from which the Company has derived a significant portion of its inventory to change the way they conduct their surplus disposition or to otherwise not renew their contracts with the Company.

The Company has evaluated subsequent events through December 11, 2009, which is the date that these financial statements have been issued and filed with the Securities and Exchange Commission.

**2. Summary of Significant Accounting Policies**

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

**Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

**Cash and Cash Equivalents**

The Company considers all highly liquid securities purchased with an initial maturity of three months or less to be cash equivalents.

**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 years ended

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**2. Summary of Significant Accounting Policies (Continued)**

September 30, 2009, 2008 and 2007, the amount of unrealized (losses) or gains reported in accumulated other comprehensive income was (\$4,000), (\$1,000) and \$178,000, 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. Interest and dividends on securities classified as available-for-sale are included in interest income and other income, net. Realized gains for sales of investments for the years ended September 30, 2009, 2008 and 2007 were \$0, \$84,000 and \$267,000, respectively.

**Inventory**

Inventory consists of property obtained for resale, generally through the online auction process, and is stated at the lower of cost or market. Cost is determined using the specific identification method. Periodically, inventories are analyzed for obsolescence. Charges for obsolete inventory are included in cost of goods sold in the period in which they have been determined to occur.

**Property and Equipment**

Property and equipment is recorded at cost, and depreciated and amortized on a straight-line basis over the following estimated useful lives:

Computers and purchased software	One to five years
Office equipment	Three years
Furniture and fixtures	Five to seven years
Leasehold improvements	Shorter of lease term or useful life

**Intangible Assets**

Intangible assets primarily consist of contract acquisition costs, covenants not to compete, and other intangible assets associated with acquisitions (see Note 4). Intangible assets are amortized using the straight-line method over their estimated useful lives, ranging from three to seven years.

**Impairment of Long-Lived Assets**

Long-lived assets, including amortizable intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. If an impairment indicator is present, the Company evaluates recoverability by comparing the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. If the assets are impaired, the impairment recognized is measured by the amount by which the carrying amount exceeds the estimated fair value of the assets.

**Goodwill**

Goodwill and other non amortizable intangible assets are reviewed 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

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**2. Summary of Significant Accounting Policies (Continued)**

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.

**Revenue Recognition**

The Company recognizes revenue in accordance with the provisions of Staff Accounting Bulletin No. 104, *Revenue Recognition*, 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 the buyer and the buyer has assumed the risks and rewards of ownership;

for arrangements with an inspection period, the buyer has received the merchandise and has not notified LSI within that period that it is dissatisfied with the merchandise; and

collection is reasonably assured.

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 the Company is deemed to be the primary obligor and bears physical and general inventory risk, and credit risk, LSI recognizes as revenue the gross proceeds from the sale, including buyer's premiums. In arrangements in which the Company acts as an agent or broker on a consignment basis, without taking physical or general inventory risk, revenue is recognized based on the sales commissions that are paid to the Company by the sellers for utilizing LSI's services; in this situation, sales commissions represent a percentage of the gross proceeds from the sale that the seller pays to the Company upon completion of the transaction.

The Company has evaluated its revenue recognition policy related to sales under LSI's profit-sharing model and determined it is appropriate to account for these sales on a gross basis. In the Company's evaluation, the Company relied most heavily upon its status as primary obligor in the sales relationship and the fact that the Company has general inventory risk.

The Company collects and remits sales taxes on merchandise that it purchases and sells, and reports such amounts under the net method in its consolidated statements of operations.

**Cost of Goods Sold**

Cost of goods sold includes the costs of purchasing and transporting property for auction as well as credit card transaction fees. The Company purchases the majority of its inventory at a fixed percentage of the property's original acquisition cost. Title for the inventory passes to the Company at that point and the Company bears the risks and rewards of ownership. The Company does not have title to assets sold on behalf of its commercial or government customers when it receives only sales commission revenue and, as such, recognizes no cost of goods sold associated with those sales. Cost of goods sold also includes shipping and handling costs and amounts paid by customers for shipping and handling.

**Risk Associated with Certain Concentrations**

The Company does not perform credit evaluations for the majority of its buyers. However, substantially all sales are recorded subsequent to payment authorization being received. As a result, the



Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**2. Summary of Significant Accounting Policies (Continued)**

Company is not subject to significant collection risk, as goods are generally not shipped before payment is received.

For consignment sales transactions, funds are collected from buyers and are held by the Company on the sellers' behalf. The funds are included in cash and cash equivalents in the consolidated financial statements. The Company releases the funds to the seller, less the Company's commission and other fees due, after the buyer has accepted the goods or within 30 days, depending on the state where the buyer and seller conduct business. The amount of cash held on behalf of the sellers is recorded as customer payables in the accompanying consolidated balance sheets.

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents in banks over FDIC limits, short-term investments and accounts receivable. The Company deposits its cash with financial institutions that the Company considers to be of high credit quality.

For the years ended September 30, 2009, 2008 and 2007, no single buyer accounted for 10% or more of revenue.

**Income Taxes**

The Company accounts for income taxes using an 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 the Company believes will more likely than not be realized. The resulting net deferred tax asset reflects management's estimate of the amount that will be realized.

The Company adopted the provisions of new authoritative guidance issued by the Financial Accounting Standards Board (FASB) related to uncertainty in income taxes on October 1, 2007. The adoption of this new authoritative literature did not impact the Company's financial position or results of operations. The Company has concluded that there were no uncertain tax positions identified during its analysis.

**Stock-Based Compensation**

At September 30, 2009, the Company had a stock-based employee compensation plan, which is described more fully in Note 11. Effective October 1, 2005, the Company adopted the fair value recognition provisions of the new authoritative guidance issued by the FASB using the prospective-transition method. Under this transition method, compensation cost recognized in the years ended September 30, 2009, 2008 and 2007 includes compensation cost for all share-based payments granted subsequent to October 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of this new authoritative guidance. Results for prior periods have not been restated.

As a result of adopting this new authoritative guidance on October 1, 2005, the Company's income before provision for income taxes and net income for the years ended September 30, 2009, 2008 and 2007 were approximately \$6,465,000 and \$2,702,000; \$4,674,000 and \$2,687,000; and \$1,942,000 and \$1,158,000 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 September 30, 2009 was approximately \$15,957,000, which will be recognized over the

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**2. Summary of Significant Accounting Policies (Continued)**

weighted average vesting period of 25 months. The Company utilizes the Black-Scholes option pricing model to determine its shared-based compensation expense. Inputs into the Black-Scholes model include volatility rates that ranged from 40% - 72%, a dividend rate of 0%, and risk-free interest rates that ranged from 0.91% to 5.05% for the years ended September 30, 2009, 2008 and 2007. The Company anticipates a forfeiture rate of 18.6% based on its historical forfeiture rate. As a result of adopting of the new authoritative guidance on October 1, 2005, the Company's basic and diluted earnings per share for the years ended September 30, 2009, 2008 and 2007 are approximately \$0.10 and \$0.10; \$0.10 and \$0.10; and \$0.04 and \$0.04, respectively, lower than if it had continued to account for share-based compensation under the previous authoritative guidance.

The Company presents the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) as a financing activity in the Consolidated Statements of Cash Flows.

**Advertising Costs**

Advertising expenditures are expensed as incurred. Advertising costs charged to expense were \$3,643,000, \$3,068,000 and \$3,648,000 for the years ended September 30, 2009, 2008 and 2007, respectively.

**Fair Value of Financial Instruments**

Cash and cash equivalents, short-term investments, accounts receivable, accounts payable, profit-sharing distributions payable, consignment payables and long-term debt reported in the consolidated balance sheets approximate their fair values.

**Foreign Currency Translation**

The functional currency for LSL, the Company's foreign subsidiary, is the British pound. The translation of the subsidiary's financial statements into U.S. dollars is performed for balance sheet accounts using exchange rates in effect at the balance sheet date and for revenue and expense accounts using an average exchange rate during the period. The resulting translation adjustments are recognized in accumulated other comprehensive income, a separate component of stockholders' equity. Realized foreign currency transaction gains and losses are included in interest income and other income, net in the consolidated statements of operations.

**Comprehensive Income**

Comprehensive income 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 years ended September 30, 2009, 2008 and 2007, respectively, comprehensive income was \$3,818,000, \$9,183,000 and \$11,425,000.

**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

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****2. Summary of Significant Accounting Policies (Continued)**

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 10,292 unvested restricted shares, which were issued at a price of \$11.66 during the year ended September 30, 2008, of which only 622 shares have been included in the calculation of diluted income per share for the year ended September 30, 2008. The Company had 462,836 unvested restricted shares, which were issued at a prices ranging from \$7.48 - \$11.48, during the year ended September 30, 2009, of which only 87,462 shares have been included in the calculation of diluted income per share for the year ended September 30, 2009, due to the significant difference between the issuance price and the average market price for the period in which they have been outstanding. The Company has also not included the following stock options in the calculation of diluted income per share because the option exercise prices were greater than the average market prices for the applicable periods:

- (a) for the fiscal year ended September 30, 2009 3,236,904 options;
- (b) for the fiscal year ended September 30, 2008 2,765,313 options; and
- (c) for the fiscal year ended September 30, 2007 38,000 options.

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

	September 30,		
	2009	2008	2007
	(dollars in thousands except per share and share data)		
Weighted average shares calculation:			
Basic weighted average shares outstanding	27,699,223	27,964,748	27,768,679
Treasury stock effect of options, warrants, and restricted stock	147,470	187,130	378,244
Diluted weighted average common shares outstanding	27,846,693	28,151,878	28,146,923
Net income	\$ 5,719	\$ 11,553	\$ 11,019
Net income per common share:			
Basic income per common share	\$ 0.21	\$ 0.41	\$ 0.40
Diluted income per common share	\$ 0.21	\$ 0.41	\$ 0.39

**Recent Accounting Pronouncements**

In December 2007, the FASB issued new authoritative guidance related to business combinations. This guidance changes the accounting for acquisitions specifically eliminating the step acquisition model, changing the recognition of contingent consideration from being recognized when it is probable of being recognized at the time of acquisition, disallowing the capitalization of transaction costs and delays when restructurings related to acquisitions can be recognized. The Company will adopt this guidance on October 1, 2009 and it will only impact the accounting for acquisitions it makes after its adoption, except for the amendment related to income taxes, which will be applied prospectively as of the adoption date and will apply to business combinations with acquisition dates before the effective date of this new guidance

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**3. Significant Contracts**

*DRMS*

The Company had a Surplus Contract with the Department of Revitalization and Marketing Services (DRMS) which expired on December 17, 2008. Under the terms of the original contract, the Company distributes to DRMS a fixed percentage of the profits realized from the ultimate sale of the inventory, after deduction for allowable expenses and profit-sharing distributions, as provided for under the terms of the contract. Profit-sharing distributions to the DRMS for the years ended September 30, 2009, 2008 and 2007 were \$18,009,000, \$41,368,000 and \$30,609,000, respectively, including accrued amounts of \$70,000 and \$3,510,000 as of September 30, 2009 and 2008, respectively.

The Company responded to a RFP and was awarded the new Surplus Contract. Significant operations began under the new Surplus Contract during February 2009. 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 DRMS available for sale within the United States, Puerto Rico, and Guam.

The Company has a Scrap Contract with DRMS, which expires in June 2012. Under the terms of the Scrap Contract, the Company is required to purchase all scrap government property referred to it by DRMS. The Company distributes to DRMS a fixed percentage of the profits realized from the ultimate sale of the inventory, after deduction for allowable expenses and profit-sharing distributions, 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 contract also has performance incentive that allows it to receive up to an additional 2% of the profit sharing distribution. This incentive is measured annually on June 30<sup>th</sup>, and is applied to the prior 12 months. For the years ended September 30, 2009, 2008 and 2007, profit-sharing distributions to the DRMS under the Scrap Contract amounted to \$25,713,000, \$47,997,000 and \$35,827,000, including accrued amounts, as of September 30, 2009 and 2008, of \$4,468,000 and \$6,744,000, respectively. The Scrap Contract may be terminated by either the Company or DRMS 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 September 30, 2009.

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

*DSA*

The Company has a contract with the UK Disposal Services Agency (DSA), which is responsible for the disposal of surplus property of the UK Ministry of Defence and the Defence Logistics Organization. The Company is required to disburse to DSA a percentage that varies based on the total annual sales volume. Distributions to DSA for the years ended September 30, 2009, 2008 and 2007 were \$1,611,000, \$1,748,000 and \$2,287,000, respectively, including accrued amounts, as of September 30, 2009 and 2008, of \$0 and \$58,000, respectively. The contract expires in July 2010.

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****4. Acquisitions*****STR***

On October 16, 2006, the Company acquired substantially all of the assets of the wholesale business of STR, Inc. (STR), a traditional liquidator, for approximately \$9,856,000 in cash, which has been adjusted as of September 30, 2007 for the final agreed upon working capital adjustment. The operating results of STR are included in the consolidated financial statements from the date of acquisition.

Goodwill was created as part of the acquisition as the Company acquired an experienced and knowledgeable workforce, along with customer lists and non-contractual customer relationships. The purchase consideration was allocated to acquired tangible assets, identifiable intangible assets, liabilities assumed and goodwill as follows:

	<b>Consideration Amount</b>
	<b>(in thousands)</b>
Goodwill	\$ 7,812
Inventory	1,262
Covenants not to compete	500
Property and equipment	388
Net other liabilities	(106)
 Total consideration	 \$ 9,856

***GovDeals***

On January 1, 2008, the Company acquired the stock of Information Management Specialists, Inc. and its GovDeals, Inc. subsidiary for approximately \$9,404,000 in cash net of acquired cash of \$742,000. GovDeals is an online auction marketplace for the sale of surplus and confiscated items for local and state government entities including city, county and state agencies as well as school boards and public utilities. The operating results of GovDeals have been included in the consolidated financial statements from the date of acquisition.

Goodwill was created as part of the acquisition as the Company acquired an experienced and knowledgeable workforce, along with customer lists and non-contractual customer relationships. The purchase consideration was allocated to acquired tangible assets, identifiable intangible assets, liabilities assumed and goodwill as follows:

	<b>Consideration Amount</b>
	<b>(in thousands)</b>
Goodwill	\$ 8,321
Cash, receivables and other assets	1,342
Covenants not to compete, brand and technology intangibles	1,095
Property and equipment	162
Deferred tax liability	(423)
Other liabilities	(351)
 Total consideration	 \$ 10,146

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****4. Acquisitions (Continued)***Geneva*

On May 1, 2008, the Company, through its LSL subsidiary, acquired the stock of the companies in the Geneva Group (Geneva), including Geneva Industries Ltd., Willen Trading Ltd., and Geneva Auctions Ltd., for approximately \$16,229,000 in cash, net of acquired cash, of \$934,000. In addition, the Company may be required to pay contingent earn-out payments of up to an aggregate of approximately \$1,640,000 payable over the next two years, which will be recorded when the Company determines that such payments are probable. No payments were earned as of September 30, 2009. The Geneva Group is a leading United Kingdom (UK) based remarketer of reverse supply chain merchandise, including customer returns and overstock merchandise. The operating results of Geneva have been included in the consolidated financial statements from the date of acquisition.

Goodwill was created as part of the acquisition as the Company acquired an experienced and knowledgeable workforce, along with customer lists and non-contractual customer relationships. The purchase consideration was allocated to acquired tangible assets, identifiable intangible assets, liabilities assumed and goodwill as follows:

	<b>Consideration Amount (in thousands)</b>
Goodwill	\$ 16,560
Cash, receivables and other assets	1,695
Inventory	1,475
Covenants not to compete and technology intangibles	1,298
Property and equipment	233
Deferred tax liability, net	(142)
Other liabilities	(3,956)
 Total consideration	 \$ 17,163

Goodwill for Geneva as of September 30, 2009, stated in U.S. dollars, was \$13,646,000 a reduction of \$2,914,000 from the time of acquisition, May 1, 2008, as a result of foreign currency translation adjustments, which are reflected as adjustments in the Consolidated Statements of Stockholders' Equity.

*Contingent Acquisition Payments*

As a result of acquisitions, as of September 30, 2009, the Company may be required to pay contingent earn-out payments of up to an aggregate of approximately \$6,050,000 payable over the next two years, which will be recorded when the Company determines that such payments are probable.

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****5. Property and Equipment**

Property and equipment, including equipment under capital lease obligations, consists of the following:

	September 30,	
	2009	2008
	(in thousands)	
Computers and purchased software	\$ 5,062	\$ 3,606
Office/Operational equipment and vehicles	4,285	3,436
Furniture and fixtures	663	610
Leasehold improvements	2,740	1,719
	12,750	9,371
Less: accumulated depreciation and amortization	(6,603)	(4,641)
	\$ 6,147	\$ 4,730

Depreciation and amortization expense related to property and equipment for the years ended September 30, 2009, 2008 and 2007 was \$2,154,000, \$1,911,000, and \$1,157,000, respectively.

**6. Intangible Assets**

Intangible assets at September 30, 2009 consisted of the following:

	Useful Life (in years)	Gross Carrying Amount	Accumulated Amortization & Foreign Currency Translation Adjustment	Net Carrying Amount
		(dollars in thousands)		
Contract intangible	7	\$ 5,694	\$ (3,389)	\$ 2,305
Brand and technology	3 - 5	688	(266)	422
Covenants not to compete	3 - 5	2,685	(1,336)	1,349
Patent and trademarks	3 - 10	188	(61)	127
Total intangible assets, net				\$ 4,203

Future expected amortization of intangible assets at September 30, 2009 was as follows:

**Years ending September 30,**

	(in thousands)
2010	\$ 1,636
2011	1,455
2012	1,000
2013	65
2014 and after	47

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****7. Debt****Senior Credit Facility**

In December 2002, and as subsequently amended, the Company entered into a senior credit facility (the Agreement) with a bank, which provides for borrowings up to \$30.0 million. This senior credit facility will expire in March 2010.

Borrowings under the Agreement bear interest at an annual rate equal to the 30 day LIBOR rate plus 1.5% (1.747% at September 30, 2009) due monthly. As of September 30, 2009 and 2008, 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). As of September 30, 2009, the Company was in compliance with these covenants.

**8. Commitments****Leases**

The Company leases certain office space and equipment under non-cancelable operating and capital lease agreements, which expire at various dates through 2014. Certain of the leases contain escalation clauses and provide for the pass-through of increases in operating expenses and real estate taxes. Rent related to leases that have escalation clauses is recognized on a straight-line basis. Resulting deferred rent charges are included in other long-term liabilities and were \$168,000 and \$274,000 at September 30, 2009 and 2008, respectively. Future minimum payments under the leases as of September 30, 2009 are as follows:

Years ending September 30,	Operating	Capital
	(in thousands)	
2010	\$ 6,513	\$ 69
2011	5,464	59
2012	3,488	29
2013	1,861	
2014 and after		
Total future minimum lease payments	\$ 17,326	157
Less: amount representing interest		19
Present value of net minimum lease payments		138
Less: current portion of capital lease obligations		56
Capital lease obligations, noncurrent		\$ 82

Amortization of fixed assets acquired through capital leases is included in depreciation and amortization expense.

Rent expense for the years ended September 30, 2009, 2008 and 2007 was \$7,908,000, \$5,660,000 and \$4,585,000, respectively.

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****9. 401(k) Benefit Plan**

The Company has various retirement plans (the Plans), which are intended to be qualified plans under Section 401(k) of the Internal Revenue Code. The Plans are defined contribution plans, available to all eligible employees and allow participants to contribute up to the legal maximum of their eligible compensation, not to exceed the maximum tax-deferred amount allowed by the Internal Revenue Service. The Plans also allow the Company to make discretionary matching contributions. For the years ended September 30, 2009, 2008 and 2007, the Company contributed and recorded expense of approximately \$579,000, \$552,000 and \$435,000, respectively, to the Plans.

**10. Income Taxes**

The components of the provision for income taxes are as follows:

	Years ended September 30,		
	2009	2008	2007
	(in thousands)		
Current tax provision:			
U.S. Federal	\$ 7,128	\$ 8,268	\$ 8,104
State	2,367	1,878	1,652
Foreign		(295)	
	9,495	9,851	9,756
Deferred tax benefit:			
U.S. Federal	(1,358)	(779)	(1,913)
State	(348)	(191)	(383)
Foreign	172	(335)	
	(1,534)	(1,305)	(2,296)
Total provision	\$ 7,961	\$ 8,546	\$ 7,460

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****10. Income Taxes (Continued)**

Deferred taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

	September 30,	
	2009	2008
	(in thousands)	
Deferred tax assets:		
Net operating losses Foreign	\$ 1,580	\$ 666
Accrued vacation and bonus	762	740
Inventory capitalization	2,317	2,428
Allowance for doubtful accounts	214	193
Depreciation	161	97
Other	3,775	2,336
Total deferred tax assets before valuation allowance	8,809	6,460
Less: valuation allowance	(1,495)	(208)
Net deferred tax assets	7,314	6,252
Deferred tax liabilities:		
Amortization of goodwill and intangibles	1,383	1,319
Other	834	1,138
Total deferred tax liabilities	2,217	2,457
Net Deferred taxes	\$ 5,097	\$ 3,795

The reconciliation of the U.S. federal statutory rate to the effective rate is as follows:

	Years ended September 30,		
	2009	2008	2007
U.S. statutory rate	35.0%	35.0%	35.0%
Permanent items	1.5%	3.9%	0.7%
State taxes	7.3%	5.2%	4.5%
Changes in valuation allowance and other	12.4%	(1.2%)	0.2%
Net foreign rate differential	2.0%	(0.4%)	
Provision for income taxes	58.2%	42.5%	40.4%

At September 30, 2009, the Company had available foreign net operating loss (NOL) carryforwards of approximately \$961,000, related to its UK subsidiary, which do not expire. The valuation allowance at September 30, 2008 relates to the foreign NOLs. During fiscal 2008, the Company reversed \$393,000 of valuation allowance recorded against UK NOLs as it was determined that it was more likely than not that the deferred tax asset would be realized. As a result of significant losses in the U.K. subsidiary during fiscal year 2009, the Company recorded a full valuation allowance related to NOLs at its UK subsidiary. The remaining NOLs and valuation allowance at September 30, 2009 were related to the Company's German and China subsidiaries and operations, which were closed down during fiscal 2009.

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**10. Income Taxes (Continued)**

The Company adopted the provisions of new authoritative guidance issued by the FASB related to uncertainty in income taxes on October 1, 2007. The adoption of this new guidance did not impact the Company's financial position or results of operations. 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. and Germany. Currently, the Company is subject to an income tax examination in one jurisdiction. The statute of limitations for years prior to fiscal 2006 is now closed. However, certain tax attribute carryforwards that were generated prior to fiscal 2006 may be adjusted upon examination by tax authorities if they are utilized.

**11. 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.

**2006 Omnibus Long-Term Incentive Plan**

In conjunction with the Company's initial public offering, the board of directors and the Company's shareholders approved the 2006 Omnibus Long-Term Incentive Plan, or the 2006 Plan, on December 2, 2005. The 2005 Stock Option and Incentive Plan was terminated when the 2006 Plan became effective, immediately after the closing of the initial public offering.

5,000,000 shares of common stock were initially reserved for issuance under the 2006 Plan. At September 30, 2007, there were 3,459,229 shares remaining reserved for issuance in connection with awards under the 2006 Plan. During fiscal year 2008, the Company issued options to purchase 2,459,232 shares to employees and directors with exercise prices between \$8.40 and \$13.48; options to purchase 487,834 shares have been forfeited; and 10,292 restricted shares have been issued at a price of \$11.66. At September 30, 2008, there were 1,477,539 shares remaining reserved for issuance in connection with awards under the 2006 Plan. During fiscal year 2009, the Company issued options to purchase 1,160,344 shares to employees and directors with exercise prices between \$5.53 and \$11.48, and options to purchase 363,554 shares were forfeited. During fiscal year 2009, the Company issued 521,653 restricted shares to employees and directors at prices ranging from \$7.48 to \$11.48, and 30,900 restricted shares were forfeited. 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 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. 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.

The 2006 Plan permits the granting of options to purchase shares of common stock intended to qualify as incentive stock options under the Internal Revenue Code and stock options that do not qualify as incentive stock options ("non-qualified stock options"). The exercise price of each stock

Table of Contents

**Liquidity Services, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Continued)**

**11. Stockholders' Equity (Continued)**

option may not be less than 100% of the fair market value of the common stock on the date of grant. However, if a grant recipient, who holds at least 10% of the common stock of the Company, receives an incentive stock option, the exercise price of such incentive stock option may not be less than 110% of the fair market value of the common stock on the date of grant. The term of each stock option is fixed by the compensation committee and may not exceed 10 years from the date of grant.

The compensation committee may also award under the 2006 Plan:

restricted stock, which are shares of common stock subject to restrictions;

stock units, which are common stock units subject to restrictions;

dividend equivalent rights, which are rights entitling the recipient to receive credits for dividends that would be paid if the recipient had held a specified number of shares of common stock;

stock appreciation rights, which are rights to receive a number of shares or, in the discretion of the compensation committee and subject to applicable law, an amount in cash or a combination of shares and cash, based on the increase in the fair market value of the shares underlying the right during a stated period specified by the compensation committee;

unrestricted stock, which are shares of common stock granted without restrictions as a bonus; and

performance and annual incentive awards, ultimately payable in common stock or cash, as determined by the compensation committee (the compensation committee may grant multi-year and annual incentive awards subject to achievement of specified goals tied to business criteria set forth in the 2006 Plan).

**Share Repurchase Program**

On December 2, 2008, the Company's Board of Directors approved a stock repurchase program. Under the program, the Company is authorized to repurchase up to \$10 million of the issued and outstanding shares of its 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 the Company's available cash. The Company's Board of Directors reviews the share repurchase program periodically. During the year ended September 30, 2009, 707,462 shares were purchased under the program for approximately \$3,874,000. There have been no subsequent share repurchases. As of September 30, 2009, approximately \$6,126,000 may yet be expended under the program.

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****11. Stockholders' Equity (Continued)****Stock Option Activity**

A summary of the Company's stock option activity for the years ended September 30, 2009 and 2008 is as follows:

	Options	Weighted- Average Exercise Price
Options outstanding at September 30, 2007	2,150,971	\$ 11.72
Options granted	2,459,232	12.21
Options exercised	(84,302)	4.09
Options canceled	(496,576)	15.44
Options outstanding at September 30, 2008	4,029,325	11.72
Options granted	1,160,344	8.08
Options exercised	(210,413)	5.14
Options canceled	(370,030)	13.61
Options outstanding at September 30, 2009	4,609,226	10.95
Options exercisable at September 30, 2009	2,008,515	11.73

The following table summarizes information about options outstanding at September 30, 2009:

Range of Exercise Price	Number Outstanding	Options Outstanding Weighted- Average Remaining Contractual Life	Weighted- Average Exercise Price
\$0.05	667	3.79	\$ 0.05
\$2.00 8.00	1,140,977	8.27	6.56
\$8.23 \$20.88	3,467,582	8.01	12.40
	4,609,226	8.07	10.95

The intrinsic value of outstanding and exercisable options at September 30, 2009 is approximately \$4,728,000 and \$1,934,000, respectively, based on a stock price of \$10.32 on September 30, 2009.

**12. 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

Table of Contents**Liquidity Services, Inc. and Subsidiaries****Notes to Consolidated Financial Statements (Continued)****12. Fair Value Measurement (Continued)**

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 September 30, 2009, the Company's Level 1 short-term investments of \$30,616,000 are the only financial instruments measured at fair value.

**13. Contingencies**

In January 2008, 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 DRMS 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 DRMS under the terms of the original Surplus Contract.

**14. Quarterly Results (Unaudited)**

The following table sets forth for the eight most recent quarters the selected unaudited quarterly consolidated statement of operations data. The unaudited quarterly consolidated statement of operations data has been prepared on the same basis as the Company's audited consolidated financial statements and, in the opinion of management, includes all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of this data.

	Dec. 31, 2007	Mar. 31, 2008	June 30, 2008	Three months ended			Mar. 31, 2009	June 30, 2009	Sept. 30, 2009
				Sept. 30, 2008	Dec. 31, 2008				
	(in thousands, except share and per share data)								
Revenue	\$ 59,266	\$ 62,839	\$ 71,473	\$ 70,362	\$ 55,642	\$ 59,676	\$ 58,045	\$ 62,920	
Income (loss) from operations	\$ 3,517	\$ 3,887	\$ 6,227	\$ 4,973	\$ (232)	\$ 3,012	\$ 6,263	\$ 4,121	
Net income	\$ 2,363	\$ 2,646	\$ 3,847	\$ 2,697	\$ 2	\$ 1,675	\$ 3,400	\$ 642	
Basic earnings per common share	\$ 0.08	\$ 0.10	\$ 0.14	\$ 0.10	\$ 0.00	\$ 0.06	\$ 0.12	\$ 0.02	
Diluted earnings per common share	\$ 0.08	\$ 0.10	\$ 0.14	\$ 0.10	\$ 0.00	\$ 0.06	\$ 0.12	\$ 0.02	
Basic weighted average shares outstanding	27,944,139	27,951,777	27,964,662	27,998,413	28,026,296	27,777,517	27,464,177	27,528,902	
Diluted weighted average shares outstanding	28,107,692	28,261,121	28,237,150	28,001,549	28,026,296	27,972,045	27,556,616	27,831,815	



Table of Contents

**LIQUIDITY SERVICES, INC.**  
**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**  
**(dollars in thousands)**

	Balance at beginning of period	Charged to expense	Reductions	Balance at end of period
Deferred tax valuation allowance (deducted from net deferred tax assets)				
Year ended September 30, 2007	\$ 494	\$ 8		\$ 502
Year ended September 30, 2008	502	99	\$ 393	208
Year ended September 30, 2009	\$ 208	\$ 1,287		\$ 1,495
Allowance for doubtful accounts (deducted from accounts receivable)				
Year ended September 30, 2007	\$ 200	\$ 171		\$ 371
Year ended September 30, 2008	371	148		519
Year ended September 30, 2009	\$ 519	\$ 464	\$ 370	\$ 613
Inventory allowance (deducted from inventory)				
Year ended September 30, 2008		\$ 314		\$ 314
Year ended September 30, 2009	\$ 314	\$ 500	\$ 314	\$ 500

Table of Contents

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
2.1	Share Purchase Agreements, dated as of April 5, 2008 and April 6, 2008, by and between Liquidity Services, Inc., and its wholly-owned subsidiary, Liquidity Services, Ltd., on the one hand, and David Mark Jacobs, Simon Jacobs, Darren Lee Innocent and Darren Malcolm Dorrington, on the other, incorporated herein by reference to Exhibit 2.1 to the Company's Quarterly Report on Form 10-Q filed with the SEC on August 8, 2008.
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.
4.1	Form of Certificate of Common Stock of the Company, incorporated herein by reference to Exhibit 4.1 to Amendment No. 5 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 21, 2006.
4.2	Registration Rights Agreement, dated September 3, 2004, by and between the Company and ABS Capital Partners IV, L.P., ABS Capital Partners IV-A, L.P., ABS Capital Partners IV Offshore L.P. and ABS Capital Partners IV Special Offshore L.P., incorporated herein by reference to Exhibit 4.2 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.
10.1	Defense Logistics Agency, Surplus Commercial Property, Defense Reutilization and Marketing Service, Invitation for Bids, No. 99-0001, December 2000, incorporated herein by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on November 14, 2005
10.2	Defense Logistics Agency, Multi-Year Sale of Surplus Scrap Material at Locations Nationwide, Defense Reutilization and Marketing Service, Invitation for Bids, No. 99-4001, December 7, 2004, incorporated herein by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on November 14, 2005.
10.3.1	Executive Employment Agreement, dated September 2, 2004, between the Company and William P. Angrick, III, incorporated herein by reference to Exhibit 10.3.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.3.2	Amendment to Executive Employment Agreement between the Company and William P. Angrick, III, dated January 26, 2006, incorporated herein by reference to Exhibit 10.3.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.4.1	Executive Employment Agreement, dated September 2, 2004, between the Company and Jaime Mateus-Tique, incorporated herein by reference to Exhibit 10.4.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.4.2	Amendment to Executive Employment Agreement between the Company and Jaime Mateus-Tique, dated January 25, 2006, incorporated herein by reference to Exhibit 10.4.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

<b>Exhibit No.</b>	<b>Description</b>
10.5.1	Executive Employment Agreement, dated May 15, 2001, between Government Liquidation.com, LLC and Benjamin R. Brown, incorporated herein by reference to Exhibit 10.5.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.5.2	Amendment to Executive Employment Agreement between Government Liquidation.com, LLC and Benjamin R. Brown, dated January 26, 2006, incorporated herein by reference to Exhibit 10.5.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.6.1	Executive Employment Agreement, dated January 27, 2005, between the Company and James M. Rallo, incorporated herein by reference to Exhibit 10.6.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.6.2	Amendment to Executive Employment Agreement between the Company and James M. Rallo, dated January 25, 2006, incorporated herein by reference to Exhibit 10.6.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.7.1	Executive Employment Agreement, dated June 13, 2001, between Government Liquidation.com, LLC and Thomas Burton, incorporated herein by reference to Exhibit 10.7.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.7.2	Amendment to Executive Employment Agreement between Government Liquidation.com, LLC and Thomas Burton, dated January 25, 2006, incorporated herein by reference to Exhibit 10.7.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.8.1	Executive Employment Agreement, dated November 11, 2005, between the Company and James E. Williams, incorporated herein by reference to Exhibit 10.8.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.8.2	Amendment to Executive Employment Agreement between the Company and James E. Williams, dated January 26, 2006, incorporated herein by reference to Exhibit 10.8.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.#
10.9	Executive Employment Agreement, dated October 15, 2007, between the Company and Eric C. Dean, ., incorporated herein by reference to Exhibit 2.1 to the Company's Annual Report on Form 10-K filed with the SEC on December 7, 2007.
10.10	2005 Stock Option and Incentive Plan, incorporated herein by reference to Exhibit 10.8 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on November 14, 2005.#
10.11	2006 Omnibus Long-Term Incentive Plan, incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q, filed with the SEC on May 6, 2009.#
10.12	Form of Indemnification Agreement for directors and officers, incorporated herein by reference to Exhibit 10.11 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (Registration No. 333-129656), filed with the SEC on February 1, 2006.

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

<b>Exhibit No.</b>	<b>Description</b>
10.13.1	Amendment to Commercial Venture II (CV-II) (Sales Contract Number 99-0001-0002), dated as of September 12, 2006, between Surplus Acquisition Venture, LLC (a wholly-owned subsidiary of Liquidity Services, Inc.) and Defense Reutilization and Marketing Service of the U.S. Department of Defense, incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the SEC on September 13, 2006.
10.13.2	Supplemental Agreement, dated as of May 13, 2008, relating to Commercial Venture II (CV-II) (Sales Contract Number 99-0001-0002) between Surplus Acquisition Venture, LLC (a wholly-owned subsidiary of Liquidity Services, Inc.) and the Defense Reutilization and Marketing Service of the U.S. Department of Defense, incorporated herein by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q filed with the SEC on August 8, 2008.
10.13.3	Notice of Termination of Commercial Venture II (CV-II) (Sales Contract Number 99-0001-0002), incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on September 5, 2008.
10.13.4	Supplemental Agreement 18 (Sales Contract Number 99-0001-0002), incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on November 12, 2008.
10.14	LSI Non-Employee Director Compensation Plan, incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the SEC on August 9, 2006.
10.15	Form of Notice of Stock Option Grant, incorporated herein by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K, filed with the SEC on April 4, 2006.
10.16	Lease Agreement, dated September 1, 2004, between Le Baron Investments and Southern Textile Recycling, Inc., incorporated herein by reference to Exhibit 10.15 to the Company's Annual Report on Form 10-K filed with the SEC on December 21, 2006.
10.17	Lease Agreement, dated June 8, 2006, between Le Baron Investments and Southern Textile Recycling, Inc., incorporated herein by reference to Exhibit 10.16 to the Company's Annual Report on Form 10-K filed with the SEC on December 21, 2006.
10.18	Lease Agreement, effective October 1, 2005, between the Company and ProLogis Development Services Incorporated, incorporated herein by reference to Exhibit 10.17 to the Company's Annual Report on Form 10-K filed with the SEC on December 21, 2006.
10.19	Industrial Real Estate Lease Agreement, dated January 20, 2006, between the Company and Paulus Enterprises, incorporated herein by reference to Exhibit 10.18 to the Company's Annual Report on Form 10-K filed with the SEC on December 21, 2006.
10.20	Standard Form Industrial Building Lease, effective August 1, 2006, between the Company and First Industrial Development Services, Inc., incorporated herein by reference to Exhibit 10.19 to the Company's Annual Report on Form 10-K filed with the SEC on December 21, 2006.
10.21	Standard Form Industrial Building Lease, effective March 1, 2005, between the Company and First Industrial Texas, L.P., incorporated herein by reference to Exhibit 10.20 to the Company's Annual Report on Form 10-K filed with the SEC on December 21, 2006.
10.22	First Lease Modification Agreement, effective June 1, 2006, to Lease Agreement, dated February 2, 2005, between the Company and First Industrial Texas, L.P., incorporated herein by reference to Exhibit 10.21 to the Company's Annual Report on Form 10-K filed with the SEC on December 21, 2006.

## Edgar Filing: LIQUIDITY SERVICES INC - Form 10-K

### Table of Contents

<b>Exhibit No.</b>	<b>Description</b>
10.23	Amendment No. 1 to Sales Contract Number 99-4001-0004, dated as of May 21, 2007, between DOD Surplus, LLC (a wholly-owned subsidiary of Liquidity Services, Inc.) and the Defense Reutilization and Marketing Service of the U.S. Department of Defense, incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on May 29, 2007.
10.24	Amendment No. 2 to Sales Contract Number 99-4001-0004, dated as of May 21, 2007, between DOD Surplus, LLC (a wholly-owned subsidiary of Liquidity Services, Inc.) and the Defense Reutilization and Marketing Service of the U.S. Department of Defense, incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed with the SEC on May 29, 2007.
10.25	Loan Agreement between the Company, Surplus Acquisition Venture, LLC (a wholly-owned subsidiary of the Company) and United Bank, including the first modification to the Loan Agreement, dated as of July 28, 2005; the second modification to the Loan Agreement, dated as of June 19, 2006; the third modification to the Loan Agreement, dated November 2, 2006; the fourth modification to the Loan Agreement, dated February 14, 2007 and the Fifth Modification to the Loan Agreement, dated as of October 17, 2007, [incorporated herein by reference to Exhibits 10.1 and 10.2 to the Company's Current Report on Form 8-K[A], filed with the SEC on February 21, 2008.
10.26	Surplus Usable Property Sales Contract (Sales Contract Number 08-0001-0001) between Liquidity Services, Inc. and the Defense Reutilization and Marketing Service of the U.S. Department of Defense, incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on August 6, 2008.
10.27	Supplemental Agreement 1 (Sales Contract Number 08-0001-0001), incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on February 5, 2009.
10.28	Form of Notice of Restricted Stock Grant, incorporated herein by reference to Exhibit 10.27 to the Company's Annual Report on Form 10-K filed with the SEC on December 8, 2009.#
21.1	List of Subsidiaries
23.1	Consent of Ernst & Young LLP
24.1	Power of Attorney (included on signature page)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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.

#

Designates management or compensation plans.

Table of Contents

**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 December 11, 2009.

LIQUIDITY SERVICES, INC.

By: /s/ WILLIAM P. ANGRICK, III

---

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

We, the undersigned directors and officers of Liquidity Services, Inc., hereby severally constitute William P. Angrick, III and James E. Williams, and each of them singly, our true and lawful attorneys with full power to them and each of them to sign for us, in our names in the capacities indicated below, any and all amendments to this Annual Report on Form 10-K filed with the Securities and Exchange Commission.

Pursuant to the requirements of the Securities Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on December 11, 2009.

<b>Signature</b>	<b>Title</b>
/s/ WILLIAM P. ANGRICK, III <hr/> William P. Angrick, III	Chairman of the Board of Directors and Chief Executive Officer (Principal Executive Officer)
/s/ JAMES M. RALLO <hr/> James M. Rallo	Chief Financial Officer and Treasurer (Principal Financial Officer and Principal Accounting Officer)
/s/ JAIME MATEUS-TIQUE <hr/> Jaime Mateus-Tique	Director
/s/ PHILIP A. CLOUGH <hr/> Phillip A. Clough	Director
/s/ PATRICK W. GROSS <hr/> Patrick W. Gross	Director
/s/ FRANKLIN D. KRAMER <hr/> Franklin D. Kramer	Director
/s/ F. DAVID FOWLER <hr/> F. David Fowler	Director