DIGITAL IMPACT INC /DE/
Form 10-Q
February 14, 2003

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

FORM 10-Q

(Mark One)

X Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2002

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: 000-27787

DIGITAL IMPACT, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-3286913**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

177 Bovet Road
San Mateo, California 94402

(Address of principal executive offices)

Telephone Number (650) 356-3400

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934:

Yes [ ] No [X]

As of February 12, 2003, there were approximately 30.7 million shares of the Registrant s Common Stock outstanding.

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION
ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
CONDENSED CONSOLIDATED BALANCE SHEETS
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
ITEM 4. CONTROLS AND PROCEDURES
PART II. OTHER INFORMATION
ITEM 1. LEGAL PROCEEDINGS
ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS
ITEM 3. DEFAULTS UPON SENIOR SECURITIES
ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
ITEM 5. OTHER INFORMAITON
ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K
SIGNATURES
CERTIFICATION
EXHIBIT INDEX
EXHIBIT 10.17
EXHIBIT 10.18
EXHIBIT 99.1

Table of Contents

DIGITAL IMPACT, INC.

INDEX

		Page No.
	PART I. FINANCIAL INFORMATION	
Item 1.	**Condensed Consolidated Financial Statements:**	
	Condensed Consolidated Statements of Operations for the three and nine months ended December 31, 2002 and 2001	3
	Condensed Consolidated Balance Sheets as of December 31, 2002 and March 31, 2002	4
	Condensed Consolidated Statements of Cash Flows for the nine months ended December 31, 2002 and 2001	6
	Notes to Condensed Consolidated Financial Statements	7
Item 2.	**Management s Discussion and Analysis of Financial Condition and Results of Operations**	12
Item 3.	**Quantitative and Qualitative Disclosures about Market Risk**	24
Item 4.	**Controls and Procedures**	24
	PART II. OTHER INFORMATION	
Item 1.	**Legal Proceedings**	25
Item 2.	**Changes in Securities and Use of Proceeds**	25
Item 3.	**Defaults Upon Senior Securities**	25
Item 4.	**Submission of Matters to a Vote of Security Holders**	25
Item 5.	**Other Information**	25
Item 6.	**Exhibits and Reports on Form 8-K**	26
	Signatures	27
	Certification	28

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

DIGITAL IMPACT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three months ended December 31,		Nine months ended December 31,	
	2002	**2001**	**2002**	**2001**
Revenues	$11,490	$10,329	$33,136	$ 28,755
Cost of revenues	4,536	4,840	13,391	13,612
Gross margin	6,954	5,489	19,745	15,143
Operating expenses:				
Research and development	1,722	2,332	5,440	8,733
Sales and marketing	3,486	3,576	10,493	12,480
General and administrative	1,824	1,948	5,424	6,566
Stock-based compensation	15	278	443	2,428
Amortization of goodwill		375		1,125
Amortization of purchased intangibles	161	161	483	483
Total operating expenses	7,208	8,670	22,283	31,815
Loss from operations	(254)	(3,181)	(2,538)	(16,672)
Other income and (expense)	(43)	(26)	(115)	299
Net loss	$ (297)	$ (3,207)	$ (2,653)	$(16,373)
Net loss per common share basic and diluted	$ (0.01)	$ (0.11)	$ (0.09)	$ (0.59)
Shares used in net loss per common share calculation basic and diluted	30,510	28,340	30,050	27,650

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

DIGITAL IMPACT, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	December 31, 2002	March 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 23,897	$ 23,937
Short-term investments	218	1,651
Accounts receivable, net	7,526	8,191
Prepaid expenses and other current assets	1,437	1,504
Total current assets	33,078	35,283
Property and equipment, net	10,324	9,484
Restricted cash	1,114	1,141
Intangible assets	2,377	2,860
Other assets	748	865
Total assets	$ 47,641	$ 49,633
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,430	$ 2,529
Accrued payroll	1,431	1,499
Accrued liabilities	2,674	2,706
Deferred revenues	1,530	829
Current portion of capital lease obligations	403	320
Current portion of long term debt	1,364	1,537
Total current liabilities	9,832	9,420
Capital lease obligations, less current portion	32	73
Long term debt, less current portion	200	1,251
Total liabilities	10,064	10,744
Stockholders equity:		
Common Stock	30	30
Additional paid-in capital	142,411	141,877
Accumulated other comprehensive loss	(31)	
Unearned stock-based compensation	(249)	(1,169)

Accumulated deficit	(104,058)	(101,405)
Less treasury stock, at cost	(526)	(444)
Total stockholders equity	37,577	38,889
Total liabilities and stockholders equity	$ 47,641	$ 49,633

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

DIGITAL IMPACT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine months ended December 31,	
	2002	**2001**
Cash flows from operating activities		
Net loss	$ (2,653)	$ (16,373)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	4,825	6,119
Allowance for doubtful accounts	(352)	(67)
Amortization of unearned stock-based compensation	443	2,428
Changes in operating assets and liabilities:		
Accounts receivable	1,017	3,870
Prepaid expenses and other current assets	67	(762)
Restricted cash	27	(85)
Other assets	117	85
Accounts payable	320	(851)
Accrued liabilities and deferred revenue	601	(295)
Net cash provided by (used in) operating activities	4,412	(5,931)
Cash flows from investing activities		
Maturities of investments in marketable securities	1,433	
Acquisition of property and equipment	(4,197)	(1,444)
Net cash used in investing activities	(2,764)	(1,444)
Cash flows from financing activities		
Principal payments on long-term debt and capital lease obligations	(2,586)	(1,565)
Proceeds from exercise of common stock options and warrants, net of treasury stock repurchases	929	221
Net cash used in financing activities	(1,657)	(1,344)
Effect of exchange rates on cash and cash equivalents	(31)	
Net decrease in cash and cash equivalents	(40)	(8,719)
Cash and cash equivalents at beginning of period	23,937	35,038
Cash and cash equivalents at end of period	$ 23,897	$ 26,319
Supplemental non-cash information:		
Assets acquired under capital leases	$ 1,404	$ 1,093
Unearned stock-based compensation (cancellations)	$ (477)	$ (148)

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

DIGITAL IMPACT, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. THE COMPANY

Digital Impact, Inc. (the "Company"), was incorporated in California in October 1997 and reincorporated in Delaware in October 1999. Digital Impact is the premier provider of online direct marketing solutions for enterprises. The Company solutions enable corporations to create and deliver online direct marketing programs that drive revenue, influence behavior and deepen customer relationships. The Company solutions provide customer insight and powerful program execution through a combination of hosted applications, technology infrastructure and professional services.

Digital Impact derives its revenues from the sale of solutions that enable businesses to proactively communicate with their customers online. Primarily, these services have consisted of the design and execution of online direct marketing campaigns, the development and execution of customer acquisition programs and additional services provided by the Company s professional services organization. Revenue for direct marketing and acquisition campaigns is recognized when persuasive evidence of an agreement exists, the campaign has been delivered, the fee is fixed or determinable and collection of the resulting receivables is reasonably assured. Revenue generated by our professional service group is typically recognized as the service is provided.

Note 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation and liquidity

The accompanying interim consolidated financial statements include the accounts of Digital Impact and its wholly owned subsidiaries. All intercompany transactions and balances have been eliminated.

The accompanying interim consolidated financial statements are unaudited, but in the opinion of management, contain all the adjustments (consisting of those of a normal, recurring nature) considered necessary to present fairly the financial position, results of operations and cash flows for the periods presented in conformity with generally accepted accounting principles applicable to interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted under the Securities and Exchange Commission s rules and regulations. Results of operations are not necessarily indicative of the results expected for the full fiscal year or any other future period.

The accompanying interim condensed consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in Digital Impact s Annual Report on Form 10-K for the fiscal year ended March 31, 2002.

Certain reclassifications have been made to the prior year s consolidated financial statements to conform to the current year presentation. Amortization of purchased intangibles which was previously reported as a component of research and development expense has been reclassified for all periods to amortization of purchased intangibles in operating expenses. The reclassification had no effect on prior year s stockholders equity or results from operations.

For the nine months ended December 31, 2002, the Company incurred a loss from operations of approximately $2.5 million and positive cash flows from operating activities of approximately $4.4 million, compared to a loss from operations of approximately $16.7 million and negative cash flow from operating activities of approximately $5.9 million for the nine months ended December 31, 2001.

The Company continues to face risks associated with the execution of its strategy. The Company s future cash flows will depend upon: (1) the level of future sales which depend on technology and product development, changes in the marketplace, liquidity, competition from existing and new competitors which may enter the

Table of Contents

marketplace and retention of key personnel and (2) our ability to control expenses.

The Company presently uses its cash and cash equivalents to fund its operations, investing and financing activities. If, due to the risks outlined in the previous paragraph, revenues were to decline significantly, this could have an adverse effect on the Company s ability to achieve its intended business objectives.

Comprehensive income

Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Other comprehensive loss, a component of stockholders equity, recorded by the Company for the nine months ended December 31, 2002 of $31,000 was attributable to cumulative currency translation adjustments arising from the consolidation of the Company s international subsidiary. The Company did not have any additional transactions that were required to be reported in other comprehensive income during the nine months ended December 31, 2002 or 2001.

Concentration of credit risk and other risks and uncertainties

Financial instruments subjecting the Company to concentration of credit risk consist primarily of cash and cash equivalents and trade accounts receivable. The Company s cash and cash equivalents are maintained at a major U.S. financial institution. Deposits in this institution may exceed the amount of insurance provided on such deposits.

The Company s customers are primarily concentrated in the United States. The Company performs ongoing credit evaluations and establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of customers, historical trends and other information. One customer accounted for 13% of revenue for the nine months ended December 31, 2002 and 11% of accounts receivable at December 31, 2002.

Note 3. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 142 *Goodwill and Other Intangible Assets,* which established financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, *Intangible Assets*. This statement requires, among other things, that goodwill not be amortized, but tested for impairment at least annually. Digital Impact will perform its annual impairment review in the fourth quarter of each fiscal year. Application of SFAS 142 was required immediately for business combinations completed after June 30, 2001. Digital Impact adopted the provisions of SFAS 142 on April 1, 2002.

The provisions of SFAS 142 also require the completion of a transitional impairment test within six months of adoption, with any identified impairments treated as a cumulative change in accounting principle. Digital Impact completed the transitional impairment test in the second quarter of fiscal 2003 and determined that no impairment existed at transition.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities,* which nullifies Emerging Issues Task Force (EITF) Issue No. 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring).* SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred and states that an entity s commitment to exit plan, by itself, does not create a present obligation that meets the definition of a liability. SFAS No. 146 also establishes that fair value is the objective for initial measurement of the liability.

The provisions of SFAS No. 146 are effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact upon the Company s financial position, cash flows or results of operations.

In November 2002, the (FASB) issued FASB Interpretation No. 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* FIN 45 requires that a liability be recorded in the guarantor s balance

sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor s fiscal year-end. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company believes that the adoption of this standard will have no material impact on its financial statements.

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company believes that the adoption of this standard will have no material impact on its financial statements.

In December 2002, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. The Company believes that the adoption of this standard will have no material impact on its financial statements.

Note 4. NET LOSS PER SHARE

Basic net loss per share is calculated by dividing net loss by the weighted average number of vested common shares outstanding for the period. Diluted net loss per share is calculated giving effect to all dilutive potential common shares, including options, warrants and preferred stock. When there is a net loss, the diluted net loss per share does not give effect for potential dilution of repurchasable common stock or unvested options, warrants and restricted stock as these shares would be antidilutive. A reconciliation of the numerators and denominators used in the basic and diluted net loss per share amounts follows (in thousands, except per share amounts):

	Three months ended December 31,		Nine months ended December 31,	
	2002	2001	2002	2001
Numerator:				
Net loss	$ (297)	$ (3,207)	$ (2,653)	$(16,373)
Denominator:				
Weighted average common shares outstanding	30,520	28,430	30,060	28,100
Weighted average unvested common shares subject to repurchase	(10)	(90)	(10)	(450)
Denominator for basic and diluted calculation	30,510	28,340	30,050	27,650
Net loss per common share basic and diluted	$ (0.01)	$ (0.11)	$ (0.09)	$ (0.59)

Table of Contents

The following outstanding stock options and shares subject to repurchase by the Company have been excluded from the calculation of diluted net loss per common share because all such securities are antidilutive for all periods presented (in thousands):

	December 31,	
	2002	2001
Options	7,996	9,005
Shares subject to repurchase	270	838

Note 5. GOODWILL AND OTHER INTANGIBLE ASSET

The Company adopted SFAS No. 142 on April 1, 2002. Upon adoption, the Company reclassified the remaining unamortized balance of $1.2 million, representing acquired workforce from the acquisition of MineShare, to goodwill. The Company will no longer amortize the remaining balance of goodwill of $2.0 million. During the quarter ended September 30, 2002 the Company completed the initial impairment test required by the adoption of SFAS No. 142 and determined that no impairment existed at transition. Goodwill will continue to be subject to annual impairment testing.

The following table presents net loss and net loss per share for the three and nine months ended December 31, 2002 and 2001, excluding the effect of goodwill and workforce amortization for all periods presented (in thousands, except per share amounts):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2002	2001	2002	2001
Reported net loss	$ (297)	$ (3,207)	$ (2,653)	$ (16,373)
Goodwill amortization		154		462
Workforce amortization		221		663
Adjusted net income	$ (297)	$ (2,832)	$ (2,653)	$ (15,248)
Basic and Diluted net loss per share				
Reported net loss	$ (0.01)	$ (0.11)	$ (0.09)	$ (0.59)
Goodwill amortization		$ 0.00		0.02
Workforce amortization		$ 0.01		0.02
Adjusted net loss	$ (0.01)	$ (0.10)	$ (0.09)	$ (0.55)

The components of goodwill and other intangibles are as follows (in thousands):

	December 31, 2002	March 31, 2002
Goodwill	$ 28,933	$ 26,273
Assembled workforce		2,660
Purchased technology	1,930	1,930
Less: accumulated amortization	(28,486)	(28,003)
	$ 2,377	$ 2,860

Note 6. CONTINGENCIES

In June 2001, a series of putative securities class actions were filed in United States District Court for the Southern District of New York against certain investment bank underwriters for the Company s initial public offering (IPO), the Company, and various of the Company s officers and directors. The complaints, which have been consolidated under the caption In re Digital Impact, Inc. Initial Public Offering Securities Litigation, Civil Action No. 01-CV-4942, allege undisclosed and improper practices concerning the allocation of the Company s IPO shares, in violation of the federal securities laws, and seek unspecified damages on behalf of persons who purchased the Company s stock during the period from November 22, 1999 to December 6, 2000. The Court has appointed a lead plaintiff

Table of Contents

for the consolidated cases. On April 19, 2002, plaintiffs filed an amended complaint. Other actions have been filed making similar allegations regarding the IPOs of more than 300 other companies. All of these lawsuits have been coordinated for pretrial purposes as In re Initial Public Offering Securities Litigation, Civil Action No. 21-MC-92. Defendants in these cases filed omnibus motions to dismiss on common pleading issues. Oral argument on these omnibus motions to dismiss was held on November 1, 2002. The Company s officers and directors have been dismissed without prejudice in this litigation. The Company believes it has meritorious defenses to the claims against it and will defend itself vigorously. In the opinion of management, after consultation with legal counsel and based on currently available information, the ultimate disposition of these matters is not expected to have a material adverse effect on our business, financial condition or results of operations, and hence no amounts have been accrued for these cases.

Table of Contents

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion of our financial condition and results of operations in conjunction with our financial statements and related notes. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of factors including those discussed in Certain Factors Which May Impact Future Operating Results, starting on page 20. Any forward-looking statements speak only as of the date such statements are made.

OVERVIEW

Digital Impact was incorporated in California in October 1997 and reincorporated in Delaware in October 1999. Digital Impact is the premier provider of online direct marketing solutions for enterprises. Our solutions enable corporations to create and deliver online direct marketing programs that drive revenue, influence behavior and deepen customer relationships. Our solutions provide customer insight and powerful program execution through a combination of hosted applications, technology infrastructure and professional services.

Digital Impact derives its revenues from the sale of solutions that enable businesses to proactively communicate with their customers online. Primarily, these services have consisted of the design and execution of online direct marketing campaigns, the development and execution of customer acquisition programs and additional services provided by the Company s professional services organization. Revenue for direct marketing and acquisition campaigns is recognized when persuasive evidence of an agreement exists, the campaign has been delivered, the fee is fixed or determinable and collection of the resulting receivables is reasonably assured. Revenue generated by our professional service group is typically recognized as the service is provided.

As of December 31, 2002 the Company had 270 full-time employees, 8% fewer than the 293 employed on December 31, 2001. We restructured our organization throughout fiscal 2002 in order to streamline operations, reduce costs and bring our staffing structure in line with the needs of the business.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Digital Impact s consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. On an on-going basis, management evaluates its estimates and assumptions, including those related to the allowance for doubtful accounts, intangible assets, restructuring costs and contingencies and litigation. Management bases its estimates and evaluations on historical experience and various factors 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.

Management believes the following critical accounting policies, among others, affect its more significant judgments and estimates used in the preparation of its consolidated financial statements:

- revenue recognition;
- estimating valuation allowances, specifically the allowance for doubtful accounts; and
- valuation of long-lived assets and goodwill.

Revenue recognition. We generate revenue from the sale of solutions that enable

Table of Contents

businesses to proactively communicate with their customers online.

Digital Impact applies the provisions of Staff Accounting Bulletin 101 Revenue Recognition and recognizes revenue when persuasive evidence of an agreement exists, the service has been delivered, the fee is fixed or determinable and collection of the resulting receivables is reasonably assured. Customer marketing revenues are recognized on delivery of the campaigns. Revenues attributable to one-time set-up fees for service initiation are deferred and recognized ratably over the term of the client s service agreement, typically twelve months. Customer acquisition revenues are derived primarily from programs that assist clients in growing their email lists through the use of third party list rentals. Customer acquisition programs fall into three general categories: List Rental programs, Data Append programs and ProspectNet programs. List Rental programs involve the execution and delivery of email campaigns to a defined number of individuals provided by a third party list rental service. Data Append programs entail the acquisition of a client s offline customers email addresses through the use of third party data append services. ProspectNet programs involve the strategic placement of a Digital Impact client offer on a third party site for the purpose of generating new opt-in email addresses for the client. Digital Impact contracts with third party providers to deliver secure names of individuals who opt-in to join the client s email list. Digital Impact is obligated to make payments to third parties for the cost of services associated with the execution of List Rental, Data Append and ProspectNet programs. These costs are recognized in the period that the programs are executed and are netted against program revenue. Digital Impact provides other services to clients, such as strategy, solutions engineering, webpage development, creative design and data analytics. These services are typically billed as a fixed fee project or on an hourly rate. The revenue for engagements that support the delivery of future products and services, such as targeted email delivery, is deferred at the time of delivery and recognized pro-rata over the future periods of usage. The period over which the revenue is recognized varies, generally between one and twelve months, depending on the term of the contract or the estimated period of usage. Management uses its best estimates to determine the appropriate period for revenue deferral.

We assess the probability of collection based on a number of factors, including our past transaction history with the customer and the credit worthiness of the customer. New customers and certain existing customers are subject to a credit review process that evaluates each customer s financial position and ultimately its ability to pay according to the terms of the arrangement. Based on our review process, if it is determined from the outset or during the term of an arrangement that collection of the resulting receivable is not probable, then revenue is recognized on a cash-collected basis.

Allowance for doubtful accounts. The preparation of financial statements requires our management to make estimates and assumptions that affect the reported amount of assets and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Specifically, management must make estimates of the uncollectable portion of our accounts receivable. Management specifically analyzes accounts receivable and analyzes historical bad debt experience, customer concentrations, customer credit worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our accounts receivable balance was $7.5 million, net of allowance for doubtful accounts of $345,000, as of December 31, 2002.

Table of Contents

Valuation of long-lived assets and goodwill. We assess the impairment of identified intangibles, long-lived assets and goodwill annually and whenever events or a change in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period of time; and
- our market capitalization relative to net book value.

When we determine that the carrying value of intangible assets, long-lived assets and goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any potential impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

Results of Operations

The following table sets forth selected data for the periods indicated as a percentage of total revenues. These operating results are not necessarily indicative of results for any future periods.

	Three Months Ended December 31,			
	2002		2001	
Net revenue	$11,490	100%	$10,329	100%
Cost of revenue	4,536	39%	4,840	47%
Gross margin	6,954	61%	5,489	53%
Operating expenses:				
Research and development	1,722	15%	2,332	22%
Sales and marketing	3,486	31%	3,576	35%
General and administrative	1,824	16%	1,948	19%
Stock-based compensation	15	0%	278	3%
Amortization of goodwill			375	4%
Amortization of purchased intangibles	161	1%	161	1%
Total operating expenses	7,208	63%	8,670	84%
Loss from operations	(254)	(2%)	(3,181)	(31%)
Interest (expense) income, net	(43)	(1%)	(26)	0%
Net loss	$ (297)	(3%)	$ (3,207)	(31%)

Three Months Ended December 31, 2002 and 2001

Revenues. Total revenues increased by 11% to $11.5 million for the three months ended December 31, 2002 from $10.3 million for the three months ended December 31, 2001, primarily as a result of the factors listed below.

The number of clients increased from December 31, 2001 to December 31, 2002. The increase in clients is primarily the result of retention of existing clients and the addition of new mid-cap and Fortune 1000 clients. The volume of email delivered increased significantly for the three months ended December 31, 2002 over the three months ended December 31, 2001. The higher email volume was partially offset by erosion in

pricing over the twelve-month period. Additionally, revenue generated by our professional services group continued to grow as both a percentage of revenue and in absolute dollars.

Cost of Revenues. Cost of revenues consists primarily of expenses relating to the delivery of online direct marketing services, including personnel costs of our service staff, the amortization of equipment and our data center expenses.

Total cost of revenues decreased 6% to $4.5 million for the three months ended

Table of Contents

December 31, 2002 from $4.8 million for the three months ended December 31, 2001.

The decrease in costs of revenues was primarily related to a $410,000 decline in personnel and allocated costs associated with a decline in service staff headcount, and a $160,000 reduction in data center expense, offset by a $220,000 increase in depreciation expense related to the recent expansion of our data center infrastructure.

Operating Expenses. Our operating expenses are classified into three general categories: research and development, sales and marketing, and general and administrative. Although each category includes expenses that are unique to that category, some expenditures, such as compensation, employee benefits, office equipment, travel and entertainment, facilities and third-party professional service, occur in all of these categories.

We allocated the cost of information services and facilities to each of the functional areas that use the information services and facilities based on each area s relative headcount. These allocated charges include rent and other facilities related costs, communication charges and depreciation charges for furniture and office equipment.

Total operating expenses for the three months ended December 31, 2002, also include non-cash expenses related to stock-based compensation and the amortization of purchased intangibles. Total operating expenses for the quarter ended December 31, 2001 include all of the expenses listed above and amortization of goodwill.

Research and Development. Research and development expenses consist primarily of personnel related costs, outside contractor costs, and software and hardware maintenance costs. Historically, most research and development costs have been expensed as incurred. Research and development expenses declined by 26% to $1.7 million for the quarter ended December 31, 2002 from $2.3 million for the quarter ended December 31, 2001. The decline is primarily a result of a $450,000 reduction in personnel expenses, related to the reduction in our engineering and contractor staff and a $100,000 decrease in allocated overhead and maintenance costs.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs of our direct sales force and marketing staff and marketing expenses for trade shows, advertisements, promotional activities and media events. Sales and marketing expenses decreased 3% to $3.5 million for the three months ended December 31, 2002 from $3.6 million for the three months ended December 31, 2001. The decrease was primarily due to a $100,000 decline in marketing expense, and a $150,000 reduction in outside consulting and recruiting expense, offset by a $150,000 increase in personnel expenses, allocated costs and travel and entertainment.

General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate operations, including information technology, finance, accounting, human resources, facilities and legal. General and administrative expenses declined by 6% to $1.8 million for the three months ended December 31, 2002 from $1.9 million for the three months ended December 31, 2001. The overall decrease was primarily the result of a reduction in bad debt expense of $100,000 due to lower loss experience from our current client base and a decline in outside services costs of $100,000, offset by a $70,000 increase in personnel costs.

Stock-based Compensation. In connection with the granting of stock options and restricted stock to our employees and the assumption of options related to the acquisition of MineShare, we recorded unearned stock based compensation totaling approximately $17.6 million, net of forfeitures, from inception through December 31, 2002. This amount represents the total difference between the exercise prices of the stock options or the purchase price of restricted stock and the deemed fair market value of the underlying common stock for accounting purposes on the date granted. This amount is included as a component of stockholders equity and is being amortized on an accelerated basis by charges to operations over the vesting period, consistent with the methods described in FASB Interpretation No. 28.

Stock-based compensation, a non-cash expense, decreased 95% to $15,000 for the three months ended December 31, 2002 from $278,000 for the three months ended December 31, 2001. The decline was primarily attributable to the cancellation of unearned stock-based compensation for terminated employees, partially offset by

Table of Contents

stock-based compensation expense related to the granting of restricted stock during fiscal 2002.

As of December 31, 2002, approximately $249,000 of unearned stock-based compensation remains to be amortized.

Amortization of Goodwill. In accordance with SFAS No. 142, goodwill is no longer amortized as of April 1, 2002 but is periodically tested for impairment. Goodwill amortization expense of approximately $375,000 for the three months ended December 31, 2001 related to goodwill and purchased intangibles from our acquisition of MineShare. For additional information, see Note 3, Recent Accounting Pronouncements, in the Notes to Condensed Consolidated Financial Statements.

Amortization of Purchased Intangibles. Amortization of purchased intangibles consists of the amortization of purchased technology from our July 2000 acquisition of MineShare. Prior to the quarter-ended September 30, 2002 amortization of purchased intangibles was a component of research and development expense. These amounts have been reclassified to conform to the current period presentation. Amortization of purchased intangibles was $161,000 for the three months ended December 31, 2002 and 2001.

As of December 31, 2002, approximately $375,000 of purchased intangibles remains to be amortized over the remainder of fiscal 2003 and 2004.

Other Income and (expense). Other income and (expense) decreased to ($43,000) for the quarter ended December 31, 2002 from ($26,000) for the quarter ended December 31, 2001. The decrease is largely due to lower interest income on lower average cash and cash equivalents balances resulting from the use of cash to fund current operations, and lower prevailing interest rates.

Nine Months Ended December 31, 2002 and 2001

	Nine Months Ended December 31,			
	2002		2001	
Net revenue	$33,136	100%	$ 28,755	100%
Cost of revenue	13,391	40%	13,612	47%
Gross margin	19,745	60%	15,143	53%
Operating expenses:				
Research and development	5,440	16%	8,733	30%
Sales and marketing	10,493	32%	12,480	43%
General and administrative	5,424	16%	6,566	23%
Stock-based compensation	443	2%	2,428	8%
Amortization of goodwill			1,125	4%
Amortization of purchased Intangibles	483	2%	483	2%
Total operating expenses	22,283	68%	31,815	110%
Loss from operations	(2,538)	(8%)	(16,672)	(57%)
Interest (expense) income, net	(115)	(0%)	299	1%
Net loss	$ (2,653)	(8%)	$(16,373)	(56%)

Revenues. Total revenues increased by 15% to $33.1 million for the nine months ended December 31, 2002 from $28.8 million for the nine months ended December 31, 2001, primarily as a result of the factors listed below.

The number of clients increased from December 31, 2001 to December 31, 2002 and the volume of email delivered increased significantly for the nine months ended December 31, 2002 over the nine months ended December 31, 2001. The higher email volume was partially offset by erosion in pricing. Additionally, revenue generated by our professional service group continued to grow as a percentage of revenue in absolute

dollars.

Cost of Revenues. Cost of revenues consists primarily of expenses relating to the delivery of online direct marketing services, including personnel costs of our service staff, the amortization of equipment and our data center expenses.

Total cost of revenues decreased 2% to $13.4 million for the nine months ended

Table of Contents

December 31, 2002 from $13.6 million for the nine months ended December 31, 2001.

The decrease in costs of revenues was primarily related to a $350,000 reduction in personnel costs, allocated overhead and outside consulting expense and a $200,000 decrease in rent for our data center facilities, offset by a $300,000 increase in depreciation expense related to the recent expansion of our data center infrastructure and an expense increase of $120,000 related to the amortization of capitalized research and development costs for our IMPACT platform.

Research and Development. Research and development expenses consist primarily of personnel related costs, outside contractor costs, and software and hardware maintenance costs. Historically, all research and development costs have been expensed as incurred, however in the quarter ended September 30, 2002, we capitalized $92,000 of research and development expense related to the development of our IMPACT product. Research and development expenses declined by 38% to $5.4 million for the nine months ended December 31, 2002 from $8.7 million for the nine months ended December 31, 2001. The decline is primarily a result of a $3.0 million reduction in personnel costs and consulting expense, related to the reduction in our engineering and contractor staff, and a $243,000 decline in allocated overhead and maintenance expense.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs of our direct sales force and marketing staff and marketing expenses for trade shows, advertisements, promotional activities and media events. Sales and marketing expenses decreased 16% to $10.5 million for the nine months ended December 31, 2002 from $12.5 million for the nine months ended December 31, 2001. The decrease was primarily due to a decline in personnel and allocated costs of approximately $1.6 million related to our realignment activities, a $390,000 reduction in marketing promotions and a $230,000 reduction in outside consulting and recruiting expense, offset by an $80,000 increase in travel, entertainment and training expense.

General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate operations, including information technology, finance, accounting, human resources, facilities and legal. General and administrative expenses declined by 17% to $5.4 million for the nine months ended December 31, 2002 from $6.6 million for the nine months ended December 31, 2001. The overall decrease was primarily the result of a reduction in bad debt expense of $450,000 due to lower loss experience from our current client base and a decline in outside services costs of $425,000.

Stock-based Compensation. In connection with the granting of stock options and restricted stock to our employees and the assumption of options related to the acquisition of MineShare, we recorded unearned stock based compensation totaling approximately $17.6 million, net of forfeitures, from inception through December 31, 2002. This amount represents the total difference between the exercise prices of the stock options or the purchase price of restricted stock and the deemed fair market value of the underlying common stock for accounting purposes on the date granted. This amount is included as a component of stockholders equity and is being amortized on an accelerated basis by charges to operations over the vesting period, consistent with the methods described in FASB Interpretation No. 28.

Stock-based compensation, a noncash expense, decreased 82% to $443,000 for the nine months ended December 31, 2002 from $2.4 million for the nine months ended December 31, 2001. The decline was primarily attributable to the cancellation of unearned stock-based compensation for terminated employees, partially offset by stock-based compensation expense related to the granting of restricted stock during fiscal 2002.

As of December 31, 2002, approximately $249,000 of unearned stock-based compensation remains to be amortized.

Amortization of Goodwill. In accordance with SFAS No. 142, goodwill is no longer amortized as of April 1, 2002 but is periodically tested for impairment. Goodwill amortization expense of approximately $1.1 million for the nine months ended December 31, 2001 related to goodwill and purchased intangibles from our acquisition of MineShare. For additional information, see Note 3, Recent Accounting Pronouncements, in the Notes to Condensed Consolidated Financial Statements.

Amortization of Purchased Intangibles. Amortization of purchased intangibles

Table of Contents

consists of the amortization of purchased technology from our July 2000 acquisition of MineShare. Prior to the quarter-ended September 30, 2002 amortization of purchased intangibles was a component of research and development expense. These amounts have been reclassified to conform to the current period presentation. Amortization of purchased intangibles was $483,000 for the nine months ended December 31, 2002 and 2001.

As of December 31, 2002, approximately $375,000 of purchased intangibles remains to be amortized.

Other Income and (expense). Other income and (expense) decreased to ($115,000) for the nine months ended December 31, 2002 from $299,000 for the nine months ended December 31, 2001. The decrease is largely due to lower interest income on lower average cash and cash equivalents balances resulting from the use of cash to fund current operations, and lower prevailing interest rates.

Liquidity and Capital Resources

As of December 31, 2002 we had $24.1 million in cash, cash equivalents and short-term investments and $23.2 million of working capital. In addition, as of December 31, 2002, we had $1.1 million in restricted cash supporting letters of credit issued against certain contractual lease obligations.

Our operating activities generated $4.4 million of cash for the nine months ended December 31, 2002. The increase resulted from the net loss of $2.7 million, offset by non-cash items of $4.9 million, and changes in operating assets and liabilities that generated $2.2 million. Net cash used by operating activities was $5.9 million for the nine months ended December 31, 2001. The decrease resulted from the net loss of $16.4 million, offset by non-cash items of $8.5 million and changes in assets and liabilities that generated $2.0 million.

Our investing activities used approximately $2.8 million during the nine months ended December 31, 2002, which was attributable to acquisitions of property, plant and equipment of approximately $4.2 million, offset by maturities of investments in marketable securities of $1.4 million. Our investing activities used $1.4 million during the nine months ended December 31, 2001, which was attributable primarily to the acquisition of property and equipment supporting our data center infrastructure.

Our financing activities used approximately $1.7 million for the nine months ended December 31, 2002. The consumption was attributable primarily to payments on long-term debt and leases, partially offset by proceeds from the exercise of stock options and the purchase of shares through our employee stock purchase plan. Financing activities used approximately $1.3 million for the nine months ended December 31, 2001.

As of December 31, 2002 we had $24.1 million in cash, cash equivalents and short-term investments and $2.0 million in borrowings in the form of long-term debt, capital leases and a line of credit, payable in monthly installments through March 2004 with a weighted average interest rate of 14.3%.

We are committed to making cash payments in the future on three types of contracts: long-term debt, capital leases and non-cancelable operating leases. We have no off-balance sheet debt, excluding operating leases for facilities, or other unrecorded obligations and have not guaranteed the debt of any other party. We have a term loan that contains a cash covenant, which requires that we maintain a minimum of $11.5 million in unrestricted cash and cash equivalents. In the event that the covenant is violated the loan is immediately callable. As of December 31, 2002 there was $1.4 million outstanding under this loan agreement.

We have commercial commitments under letters of credit that expire in amounts of $84,000 and $1.0 million in fiscal year 2004 and fiscal year 2008, respectively.

The Company continues to face risks associated with the execution of its strategy. The Company s future cash flows will depend upon: (1) the level of future sales which depend on technology and product development, changes in the marketplace, liquidity, competition from existing and new competitors which may enter the marketplace and retention of key personnel and (2) our ability to control expenses.

The Company presently uses its cash and cash equivalents to fund its operations, investing and financing activities. If due to the risks outlined in the previous

Table of Contents

paragraph, revenues were to decline significantly, this could have an adverse effect on the Company s ability to achieve its intended business objectives.

We believe that our existing cash and cash equivalents will be sufficient to satisfy our currently anticipated cash requirements for at least the next twelve months.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, *Business Combinations,* and SFAS No. 142, *Goodwill and Other Intangible Assets.* SFAS No. 141 addresses financial accounting and reporting for business combinations and supersedes Accounting Principals Board (APB) No.16, Business Combinations. The provisions of SFAS No.141 were adopted July 1, 2001. The most significant changes made by SFAS No.141 are: (1) requiring that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, (2) establishing specific criteria for the recognition of intangible assets separately from goodwill, and (3) requiring unallocated negative goodwill to be written off immediately as an extraordinary gain.

SFAS No.142 primarily addresses the accounting for goodwill and intangible assets subsequent to their acquisition and supersedes APB No.17, Intangible Assets. The most significant changes made by SFAS No. 142 are: (1) goodwill and indefinite lived intangible assets will no longer be amortized, (2) goodwill will be tested for impairment at least annually at the reporting unit level, (3) intangible assets deemed to have an indefinite life will be tested for impairment at least annually, and (4) the amortization period of intangible assets with finite lives will no longer be limited to forty years. Digital Impact will perform its annual impairment review in the fourth quarter of each fiscal year.

We adopted SFAS No. 142 effective April 1, 2002, and as a result no longer amortize our goodwill balance of $2.0 million. As of March 31, 2002, net goodwill was $820,000, net assembled workforce was $1.2 million and goodwill amortization expense was $615,000 for the year ended March 31, 2002. We were required to measure goodwill for impairment effective April 1, 2002 as part of the transition provisions. Any impairment resulting from the transition provisions would have been recognized as the effect of a change in accounting principle. We performed the initial impairment analysis in the quarter ended September 30, 2002 and determined that no impairment currently exists.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities,* which nullifies Emerging Issues Task Force (EITF) Issue No. 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring).* SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred and states that an entity s commitment to an exit plan, by itself, does not create a present obligation that meets the definition of a liability. SFAS No. 146 also establishes that fair value is the objective for initial measurement of the liability.

The provisions of SFAS No. 146 are effective for exit or disposal activities initiated after December 31, 2002. We do not expect the adoption of SFAS No. 146 to have a material impact upon our financial position, cash flows or results of operations.

In November 2002, the (FASB) issued FASB Interpretation No. 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* FIN 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor s fiscal year-end. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. We believe that the adoption of this standard will have no material impact on our financial statements.

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the

Table of Contents

delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We believe that the adoption of this standard will have no material impact on our financial statements.

In December 2002, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. We believe that the adoption of this standard will have no material impact on our financial statements.

Certain Factors Which May Impact Future Operating Results

Our future operating results may vary substantially from period to period due to a number of factors, many of which are beyond our control. The following discussion highlights some of these factors and the possible impact of these factors on future results of operations. If any of the following factors actually occur, our business, financial condition or results of operations could be harmed. In that case, the price of our common stock could decline, and investors could experience losses on their investment.

Because of our limited operating history and the emerging nature of the online direct marketing industry, any predictions about our future revenues and expenses may not be as accurate as they would be if we had a longer business history, and we cannot determine trends that may affect our business.

We were incorporated in October 1997 in California and reincorporated in Delaware in October 1999. Our limited operating history makes financial forecasting and evaluation of our business difficult. Since we have limited financial data, any predictions about our future revenues and expenses may not be as accurate as they would be if we had a longer business history. Because of the emerging nature of the online direct marketing industry, we cannot determine trends that may emerge in our market or affect our business. The revenue and income potential of the online direct marketing industry, and our business, are unproven.

Our operating results have varied significantly in the past and are likely to vary significantly from period to period, and our stock price may decline if we fail to meet the expectations of analysts and investors.

Our operating results have varied significantly in the past and are likely to vary significantly from period to period. As a result, our operating results are difficult to predict and may not meet the expectations of securities analysts or investors. If this occurs, the price of our common stock would likely decline.

We may not be able to forecast our revenues accurately because our customers marketing budgets are difficult to predict and may fluctuate from period to period.

Our revenue and operating results depend upon the marketing budgets of our existing and new customers. These marketing budgets are difficult to predict and may vary from period to period as a result of factors that are beyond our control, including our customers marketing objectives for a particular period, the general state of the economy and our customers success in the marketplace. Consequently, we face difficulty in predicting the amount of revenues each client will generate in any particular quarter. As a result, our operating results are difficult to predict and may not meet the expectations of securities analysts or investors. If this occurs, the price of our common stock would likely decline.

We derive our revenue from advertising services, which revenues tend to be cyclical and dependent on the economic prospects of advertisers and direct marketers and the economy in general. A continued decrease in expenditures by advertisers and direct marketers or a continued downturn in the economy could cause our revenues to decline significantly in any given period.

Table of Contents

We derive, and expect to continue to derive for the foreseeable future, a large portion of our revenue from products and services we provide to advertisers, direct marketers and agencies. Expenditures by advertisers tend to be cyclical, reflecting overall economic conditions as well as budgeting and buying patterns. The overall market for advertising, including internet advertising, has been characterized in recent quarters by increasing softness of demand, lower prices for advertisements and the reduction of marketing and advertising. As a result of these reductions, advertising spending across traditional media, as well as the internet, has decreased.

We cannot assure you that further reductions in advertising spending will not occur. We also cannot assure you that if economic conditions improve, marketing budgets and advertising spending will increase from current levels. A continued decline in the economic prospects of advertisers or the economy in general could alter current or prospective advertisers spending priorities or increase the time it takes to close a sale with a customer. As a result, our revenues from advertisements and advertising services may decline significantly in any given period.

Seasonal trends may cause our quarterly operating results to fluctuate, which may adversely affect the market price of our common stock.

The traditional direct marketing industry has typically generated lower revenues during the summer months and higher revenues during the calendar year-end months. We believe our business is affected by similar revenue fluctuations, but our limited operating history is insufficient to isolate and predict the magnitude of these effects. Because we do experience these effects, analysts and investors may not be able to predict our quarterly or annual operating results. If we fail to meet expectations of analysts and investors, our stock price could decline.

If businesses and consumers fail to accept online direct marketing as a means to attract new customers, demand for our services may not develop and the price of our stock could decline.

The market for online direct marketing services is relatively new and rapidly evolving, and our business may be harmed if sufficient demand for our services does not develop. Our current and planned services are very different from the traditional methods that many of our clients have historically used to attract new customers and maintain customer relationships.

The loss of a major client could result in lower than expected revenues.

The loss of a major client could harm our business. While only one client accounted for more than 10% of our revenues for the nine months ended December 31, 2002, the loss of this client or another major client could have a material adverse effect on our business and results of operations.

The online direct marketing industry is highly competitive, and if we are unable to compete effectively, the demand for, or the prices of, our services may decline.

The market for online direct marketing is highly competitive, rapidly evolving and experiencing rapid technological change. Intense competition may result in price reductions, reduced sales, gross margins and operating margins, and loss of market share. Our principal competitors include providers of online direct marketing solutions such as DoubleClick, Responsys, Cheetahmail, Bigfoot Interactive and Yesmail, as well as the in-house information technology departments of our existing and prospective clients.

In addition, we expect competition to persist and intensify in the future, which could harm our ability to increase sales and maintain our prices. In the future, we may experience competition from internet service providers, advertising and direct marketing agencies and other large established businesses possessing large, existing customer bases, substantial financial resources and established distribution channels and could develop, market or resell a number of online direct marketing solutions. These potential competitors may also choose to enter, or have already entered, the market for online direct marketing by acquiring one of our existing competitors or by forming strategic alliances with a competitor.

Many of these potential competitors have broad distribution channels and they may bundle competing products or services. As a result of future competition, the

Table of Contents

demand for our services could substantially decline. Any of these occurrences could harm our ability to compete effectively.

If we fail to respond to changing customer preferences in our market, demand for our technology and services may decline, causing our revenues to suffer.

If we do not continue to develop new technology and services that keep pace with competitive developments, satisfy diverse and rapidly evolving customer requirements and achieve market acceptance, we might be unable to attract new customers and retain existing customers. The development of proprietary technology and service enhancements entails significant technical and business risks and requires substantial expenditures and lead-time. We might not be successful in marketing and supporting recently released versions of our technology and services on a timely or cost-effective basis. In addition, even if new technology and services are developed and released, they might not achieve market acceptance. We have experienced delays in releasing new or enhanced technology and services in the past and could experience similar delays in the future, which could cause us to lose customers.

If we do not attract and retain additional highly skilled personnel, we may be unable to execute our business strategy.

Our business depends on the continued technological innovation of our core products and services and our ability to provide comprehensive online direct marketing expertise. Our main offices are located in the San Francisco Bay Area and New York City, where competition for personnel with internet-related technology and marketing skills has traditionally been intense. In addition, we restructure our organization from time to time, including reductions in our workforce, to streamline operations and reduce costs. These measures may have unanticipated consequences, such as low morale, unexpected litigation and difficulty in future employee hiring and retention. If we fail to identify, attract, retain and motivate these highly skilled personnel, we may be unable to successfully introduce new services or otherwise implement our business strategy. As a public company we face greater difficulty attracting and retaining personnel than we did as a private company.

If the delivery of our email messages is limited or blocked, then the amount we may be able to charge our clients for producing and sending their campaigns may be reduced and our clients may discontinue their use of our services.

Our business model relies on our ability to deliver emails over the internet through internet service providers and to recipients in major corporations. In particular, a significant percentage of our emails are sent to recipients who use America Online. We do not have, nor are we required to have, an agreement with America Online to deliver emails to their customers. America Online uses a proprietary set of technologies to handle and deliver email and the value of our services will be reduced if we are unable to provide emails compatible with these technologies.

In addition, America Online and other internet service providers are able to block messages from reaching their users. Recent releases of internet service provider software, including AOL 8.0, and the implementation of stringent new policies by internet service providers have caused periodic temporary blockages of our ability to successfully deliver emails to the customers of AOL and certain other internet service providers. We continually improve our own technology and work with internet service providers to improve our ability to successfully deliver our emails. However, if internet service providers materially limit or halt the delivery of our emails, or if we fail to deliver emails in such a way as to be compatible with these companies email handling technologies, then the amount we may be able to charge our clients for producing and sending their online direct marketing campaigns may be reduced and our clients may discontinue their use of our services.

Our facilities and systems are vulnerable to natural disasters and other unexpected events, and any of these events could result in an interruption of our ability to execute our clients online direct marketing campaigns.

We depend on the efficient and uninterrupted operations of our data center and hardware systems. Our data center and hardware systems are located in northern California, an area susceptible to earthquakes. Our data center and hardware systems are also vulnerable to damage from fire, floods, power loss,

telecommunications failures, and similar events. If any of these events results in damage to our data center or systems, we may be unable to execute our clients online direct marketing campaigns until the damage is repaired, and may accordingly lose clients and revenues. In addition, subject to applicable insurance coverage, we may incur substantial costs in repairing any damage.

Our data center is located at facilities provided by a third party, and if this party is unable to adequately protect our data center, our reputation may be harmed and we may lose clients.

Our data center, which is critical to our ongoing operations, is located at facilities provided by a third party. Our operations depend on this party s ability to protect our data center from damage or interruption from human error, break-ins, sabotage, computer viruses, intentional acts of vandalism and similar events. If this party is unable to adequately protect our data center and information is lost or our ability to deliver our services is interrupted, our reputation may be harmed and we may lose clients.

If we are unable to protect our intellectual property, third parties could use our intellectual property without our consent.

Our ability to successfully compete is substantially dependent upon our internally developed technology and intellectual property, which we protect through a combination of patent, copyright, trade secret and trademark law, and contractual obligations. We have one issued U.S. patent and have two U.S. patent applications pending. We have several registered U.S. trademarks and have several more applications pending in the U.S., Europe and Japan. We may not be able to protect our proprietary rights. Unauthorized parties may attempt to obtain and use our proprietary information. Policing unauthorized use of our proprietary information is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

If we are unable to safeguard the confidential information in our data warehouse, our reputation may be harmed and we may be exposed to liability.

We currently store confidential customer information in a secure data warehouse. We cannot be certain, however, that we will be able to prevent unauthorized individuals from gaining access to this data warehouse. If any compromise or breach of security were to occur, it could harm our reputation and expose us to possible liability. Any unauthorized access to our servers could result in the misappropriation of confidential customer information or cause interruptions in our services. It is also possible that one of our employees could attempt to misuse confidential customer information, exposing us to liability. In addition, our reputation may be harmed if we lose customer information maintained in our data warehouse due to systems interruptions or other reasons.

Activities of our clients could damage our reputation or give rise to legal claims against us.

Our clients promotion of their products and services may not comply with federal, state and local laws. We cannot predict whether our role in facilitating these marketing activities would expose us to liability under these laws. Any claims made against us could be costly and time-consuming to defend. If we are exposed to this kind of liability, we could be required to pay fines or penalties, redesign our business methods, discontinue some of our services or otherwise expend resources to avoid liability.

Our services involve the transmission of information through the internet. Our services could be used to transmit harmful applications, negative messages, unauthorized reproduction of copyrighted material, inaccurate data or computer viruses to end-users in the course of delivery. Any transmission of this kind could damage our reputation or could give rise to legal claims against us. We could spend a significant amount of time and money defending against these legal claims.

New regulation of, and uncertainties regarding the application of existing laws and regulations to, online direct marketing and the internet could prohibit, limit or increase the cost of our business.

Legislation has been enacted in several states regulating the sending of unsolicited commercial email. We cannot assure you that existing or future

Table of Contents

legislation regarding commercial email will not harm our business. The federal government, foreign governments and several other states are considering, or have considered, similar legislation. These provisions generally limit or prohibit both the transmission of unsolicited commercial emails and the use of forged or fraudulent routing and header information. Some states, including California, require that unsolicited commercial emails include opt-out instructions and that senders of these emails honor any opt-out requests.

Our business could be negatively impacted by new laws or regulations applicable to online direct marketing or the internet, the application of existing laws and regulations to online direct marketing or the internet or the application of new laws and regulations to our business as we expand into new jurisdictions. There is a growing body of laws and regulations applicable to access to, or commerce, on the internet. Moreover, the applicability to the internet of existing laws is uncertain and may take years to resolve. Due to the increasing popularity and use of the internet, it is likely that additional laws and regulations will be adopted covering issues such as privacy, pricing, content, copyrights, distribution, taxation, antitrust, characteristics and quality of services and consumer protection. The adoption of any additional laws or regulations may impair the growth of the internet or online direct marketing, which could, in turn, decrease the demand for our services and prohibit, limit or increase the cost of our doing business.

Internet-related stock prices are especially volatile and this volatility may depress our stock price.

The stock market and specifically the stock prices of internet-related companies have been very volatile. Because we are an internet-related company, we expect our stock price to be similarly volatile. As a result of this volatility, the market price of our common stock could significantly decrease. This volatility is often not related to our operating performance and may accordingly reduce the price of our common stock without regard to our operating performance.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For the period from our inception through December 31, 2002, we provided our services to clients primarily in the United States. As a result, our financial results have not been directly affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. The majority of our sales are currently denominated in U.S. dollars. We have a subsidiary in the United Kingdom which has had minimal operations to date. As the operations of this subsidiary expand, our future operating results could be directly impacted by changes in foreign currency exchange rates or economic conditions in this region.

Our exposure to market risk for changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio and on the increase or decrease in the amount of interest expense we must pay on outstanding debt instruments which are tied to market rates. We do not plan to use derivative financial instruments in our investment portfolio. We plan to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We plan to mitigate default risk by investing in high quality securities.

ITEM 4. CONTROLS AND PROCEDURES

a) Evaluation of disclosure controls and procedures. Within the 90 days prior to the date of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Securities Exchange Act of 1934 Rules 13a-14 and 15d-14(c). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the evaluation date, the Company s disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities Exchange Commissions s rules and forms. b) Changes in internal controls. There were no significant changes in the Company s internal controls or in other factors that could significantly affect these controls subsequent to the date of the Chief Executive s and Chief Financial

Officer s evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In June 2001, a series of putative securities class actions were filed in United States District Court for the Southern District of New York against certain investment bank underwriters for the Company s initial public offering (IPO), the Company, and various of the Company s officers and directors. The complaints, which have been consolidated under the caption In re Digital Impact, Inc. Initial Public Offering Securities Litigation, Civil Action No. 01-CV-4942, allege undisclosed and improper practices concerning the allocation of the Company s IPO shares, in violation of the federal securities laws, and seek unspecified damages on behalf of persons who purchased the Company s stock during the period from November 22, 1999 to December 6, 2000. The Court has appointed a lead plaintiff for the consolidated cases. On April 19, 2002, plaintiffs filed an amended complaint. Other actions have been filed making similar allegations regarding the IPOs of more than 300 other companies. All of these lawsuits have been coordinated for pretrial purposes as In re Initial Public Offering Securities Litigation, Civil Action No. 21-MC-92. Defendants in these cases filed omnibus motions to dismiss on common pleading issues. Oral argument on these omnibus motions to dismiss was held on November 1, 2002. The Company s officers and directors have been dismissed without prejudice in this litigation. The Company believes it has meritorious defenses to the claims against it and will defend itself vigorously. In the opinion of management, after consultation with legal counsel and based on currently available information, the ultimate disposition of these matters is not expected to have a material adverse effect on our business, financial condition or results of operations, and hence no amounts have been accrued for these cases.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

Table of Contents

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a) Exhibits

Number	Description
Exhibit 10.17 -	Amendment to Form of Retention Agreement with a Key Employee
Exhibit 10.18 -	Amendment to Form of Retention Agreement with a Key Employee
Exhibit 99.1 -	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes Oxley Act of 2002

b) Reports on Form 8-K

None

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: February 14, 2003

DIGITAL IMPACT, INC.
(Registrant)

/S/ WILLIAM PARK

William Park
President, Chief Executive Officer and
Chairman of the Board of Directors
(Principal Executive Officer)

/S/ DAVID OPPENHEIMER

David Oppenheimer
Sr. Vice President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

Table of Contents

CERTIFICATION

I, William Park, Chief Executive Officer of Digital Impact, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Digital Impact, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) Evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

Table of Contents

c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date February 14, 2003

By /S/ WILLIAM PARK

William Park
President, Chief Executive Officer and Chairman of the Board of Directors
(Principal Executive Officer)

Table of Contents

CERTIFICATION

I, David Oppenheimer, Chief Financial Officer of Digital Impact, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Digital Impact, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

Table of Contents

d) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

e) Evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

f) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

c) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

d) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date February 14, 2003

By /S/ DAVID OPPENHEIMER

David Oppenheimer
Sr. Vice President, Chief Financial Officer
and Treasurer (Principal Financial and
Accounting Officer)

EXHIBIT INDEX

Number	Description
Exhibit 10.17 -	Amendment to Form of Retention Agreement with a Key Employee
Exhibit 10.18 -	Amendment to Form of Retention Agreement with a Key Employee
Exhibit 99.1 -	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002