DIGITAL IMPACT INC /DE/
Form 10-Q
February 11, 2004

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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, 2003

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 9, 2004, there were approximately 33.5 million shares of the Registrant s Common Stock outstanding.

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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,	
	2003	**2002**	**2003**	**2002**
Revenues	$11,509	$11,490	$33,361	$33,136
Cost of revenues	4,921	4,536	14,444	13,391
Gross profit	6,588	6,954	18,917	19,745
Operating expenses:				
Research and development	1,118	1,722	3,840	5,440
Sales and marketing	3,055	3,486	9,033	10,493
General and administrative	1,943	1,824	5,381	5,424
Stock-based compensation	36	15	78	443
Amortization of purchased intangibles		161	214	483
Total operating expenses	6,152	7,208	18,546	22,283
Income (loss) from operations	436	(254)	371	(2,538)
Other income and (expense), net	53	(43)	(67)	(115)
Net income (loss)	$ 489	$ (297)	$ 304	$ (2,653)
Basic net income (loss) per share	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)
Weighted average shares used in basic net income (loss) per share	33,490	30,510	32,650	30,050
Diluted net income (loss) per share	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)
Weighted average shares used in diluted net income (loss) per share	36,022	30,510	35,193	30,050

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

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DIGITAL IMPACT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	December 31, 2003	March 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$25,578	$23,659
Short-term investments	1,606	108
Accounts receivable, net	7,928	7,903
Prepaid expenses and other current assets	1,599	1,377
Total current assets	36,711	33,047
Property and equipment, net	7,096	8,909
Restricted cash	1,163	1,114
Goodwill	2,002	2,002
Intangible assets		214
Other assets	446	731
Total assets	$47,418	$46,017
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,002	$ 1,819
Accrued payroll	1,435	1,779
Accrued liabilities	1,776	2,403
Deferred revenues	2,157	1,975
Current portion of capital lease obligations		374
Current portion of long term debt	478	1,212
Total current liabilities	7,848	9,562
Long term debt, less current portion	111	
Total liabilities	7,959	9,562
Stockholders equity:		
Preferred Stock		

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	December 31, 2003	March 31, 2003
Common Stock	31	31
Additional paid-in capital	145,221	142,482
Accumulated other comprehensive loss	(84)	(12)
Unearned stock-based compensation	(19)	(125)
Accumulated deficit	(105,075)	(105,379)
Less treasury stock, at cost	(615)	(542)
Total stockholders equity	39,459	36,455
Total liabilities and stockholders equity	$ 47,418	$ 46,017

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

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DIGITAL IMPACT, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands, except per share data)
(Unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	**2002**	**2003**	**2002**
Net income (loss)	$489	$(297)	$ 304	$(2,653)
Other comprehensive loss:				
Unrealized loss on investments	(1)		(1)	
Cumulative translation adjustment	(4)	113	(71)	(31)
Net changes in comprehensive income (loss)	(5)	113	(72)	(31)
Comprehensive income (loss)	$484	$(184)	$(232)	$(2,684)

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

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DIGITAL IMPACT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended December 31,	
	2003	**2002**
Cash flows from operating activities		
Net income (loss)	$ 304	$ (2,653)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	4,031	4,825
Recovery of bad debts	(80)	(352)
Amortization of unearned stock-based compensation	78	443
Unrealized loss on investments	(1)	
Loss on disposal of fixed assets	78	
Changes in operating assets and liabilities:		
Accounts receivable	55	1,017
Prepaid expenses and other current assets	(222)	67
Restricted cash	(49)	27
Other assets	285	117
Accounts payable	183	320
Accrued liabilities and accrued payroll	(971)	(100)
Deferred revenue	182	601
Net cash provided by operating activities	3,873	4,412
Cash flows from investing activities		
Purchases of investments in marketable securities	(1,498)	
Maturities of investments in marketable securities		1,433
Acquisition of property and equipment	(1,767)	(4,197)
Net cash used in investing activities	(3,265)	(2,764)
Cash flows from financing activities		
Principal payments on long-term debt and capital lease obligations	(1,312)	(2,586)
Proceeds from issuance of common stock	2,767	1,011
Purchases of treasury stock	(73)	(82)
Net cash provided by (used in) financing activities	1,382	(1,657)
Effect of exchange rates on cash and cash equivalents	(71)	(31)
Net increase (decrease) in cash and cash equivalents	1,919	(40)
Cash and cash equivalents at beginning of period	23,659	23,937
Cash and cash equivalents at end of period	$ 25,578	$ 23,897
Supplemental non-cash information:		
Assets acquired under capital leases and notes payable	$ 315	$ 1,404
Unearned stock-based compensation cancellations	$ (45)	$ (477)

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

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DIGITAL IMPACT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company

Digital Impact, Inc. (the Company or 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. The Company s solutions enable corporations to create and deliver online direct marketing programs that drive revenue, influence behavior and deepen customer relationships. The Company s solutions provide customer insight and powerful program execution through a combination of hosted applications, technology infrastructure and digital marketing 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 Professional Services organization.

Digital Impact is organized into two segments: Customer Marketing and Professional Services. Customer Marketing consists of creating and executing online direct marketing programs. Professional Services include several categories of services designed to improve campaign results.

Note 2. Summary of Significant Accounting Policies

Basis of presentation and liquidity

The condensed consolidated financial statements include the accounts of Digital Impact and its wholly owned subsidiary. All significant intercompany accounts and balances have been eliminated.

The accompanying interim condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. The accompanying interim condensed consolidated financial statements are unaudited, but in the opinion of management, contain all the normal, recurring adjustments considered necessary to present fairly the financial position, the results of operations and cash flows for the periods presented in conformity with generally accepted accounting principles applicable to interim periods. Results of operations are not necessarily indicative of the results expected for the full fiscal year or for any 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, 2003.

Certain reclassifications have been made to the prior year s consolidated financial statements to conform to the current year presentation. The reclassification had no effect on prior year s stockholders equity or results from operations.

The Company generated consolidated net income of $489,000 and $304,000 for the three and nine months ended December 31, 2003, respectively, compared to a consolidated net loss of $297,000 and $2.7 million for the three months and nine months ended December 31, 2002, respectively. The Company generated cash of $3.9 million from operating activities for the nine months ended December 31, 2003, compared to $4.4 million provided by operating activities for the nine months ended December 31, 2002.

The Company continues to face risks associated with the execution of its strategy. Future cash flows and capital requirements depend on numerous factors, including market acceptance of its services, competition from new and existing competitors, the amount of resources it invests in its data center infrastructure and new product development, marketing and selling its products and services, brand promotions and any future acquisitions or divestitures.

The Company s primary source of liquidity is $25.6 million in cash and cash equivalents, and $1.6 million in short-term investments.

Use of estimates

Preparation of the accompanying financial statements in conformity with generally accepted accounting principles requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported

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amounts of revenues and expenses during the reported period. Significant estimates include those required in the valuation of intangible assets acquired in business combinations, allowances for doubtful accounts and sales allowances. Actual results could differ from those estimates.

Foreign currency translation

The functional currency for the Company s U.K. subsidiary is the British Pound. Assets and liabilities are translated using the exchange rate at the balance sheet date. For the three and nine months ended December 31, 2003 the Company recorded a $25,000 gain in other income on the currency translation of short-term intercompany receivables. Revenues, expenses, gains, and losses are translated using the exchange rate at the end of the month in which the transaction occurred. Translation gains and losses are accumulated as a separate component of stockholders equity. Net gains and losses from foreign currency transactions are included in the Condensed Consolidated Statement of Operations and were not significant during any of the periods presented.

Revenue Recognition

The Company generates revenue from the sale of solutions that enable businesses to proactively communicate with its customers online.

Digital Impact applies the provisions of Staff Accounting Bulletin 104 Revenue Recognition and recognizes revenue when persuasive evidence of an arrangement 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 upon sending 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 two general categories: List Rental 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 or email address marketing service. 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 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 and ProspectNet programs. Digital Impact accounts for revenues and costs associated with Customer Acquisition programs in accordance with Emerging Issues Task Force Issue No. 99-19 (EITF 99-19), Reporting Revenue Gross as a Principal versus Net as an Agent. The cost of Customer Acquisition campaigns are recognized in the period that the programs are executed and are netted against program revenue. The cost of Customer Acquisition campaigns are estimated using Company records of outstanding purchase commitments when final vendor invoices have not been received.

Digital Impact recognizes revenue net of third-party costs because the majority of client and supplier contracts have the following characteristics: the supplier, not the Company, is the primary obligor in the arrangement, the Company has limited latitude in establishing the price charged to the client, the Company s credit risk is sometimes mitigated by receiving prepayment or reduced credit terms from its clients before ordering from the supplier, the Company does not maintain any inventory related to Customer Acquisition programs, the Company does not make changes to any data acquired from the supplier, and the client approves the supplier selection and the service specifications.

Digital Impact provides other complementary services to clients, such as strategy, solutions engineering, web-page development, creative design and data analytics. These services are typically billed on an hourly rate. The revenue for engagements that support the delivery of future products and services, such as targeted solutions, 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 their best estimates to determine the appropriate period for revenue deferral.

The Company assesses the probability of collection based on a number of factors, including its 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 the customers financial position and ultimately their ability to pay according to the original terms of the arrangement. Based on the Company s 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.

Cash, cash equivalents and short-term investments

The Company considers all highly liquid investments with an original or remaining maturity of three months or less at

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the time of purchase to be cash equivalents.

Short-term investments consist of certificates of deposit and are classified as current assets because they have a maturity of less than one year.

Digital Impact classifies short-term investments as available-for-sale. Accordingly, these investments are carried at fair value, with unrealized gains and losses reported as a separate component of stockholders equity. Digital Impact realizes gains or losses when these investments are sold using the specific identification method. Digital Impact has not recognized any material gains of losses from the sale of short-term investments.

Restricted cash of $1.2 million at December 31, 2003 represents cash pledged as collateral for letters of credit that collateralize the Company s operating leases.

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. For the nine months ended December 31, 2003, two customers represented 12% and 11% of revenue, respectively. For the nine months ended December 31, 2002, one customer represented 13% of revenue. As of December 31, 2003, one customer represented 10% of accounts receivable. As of December 31, 2002, one customer represented 11% of accounts receivable.

Research and development expense

Research and development expense consists primarily of salary and related personnel expense, consulting fees and other operating expenses related to research and development departments. The research and development departments perform new product development, enhance and maintain existing products and perform quality assurance. With the exception of capitalized software development costs, research and development costs are expensed as incurred.

The Company follows the provisions outlined in Statement of Position 98-1 Accounting for the Costs of Computer Software Developed or Obtained for Internal Use related to the treatment of costs.

The Company capitalizes certain direct costs incurred in the development of internal use software. For the nine months ended December 31, 2003, the Company capitalized $278,000 in software development costs. These costs will be amortized using the straight-line method over the two-year estimated useful life of the software, beginning when the software is ready for use. These amounts are included in property and equipment in the accompanying consolidated balance sheet.

Long-lived assets

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization is computed using the straight-line method over the shorter of the estimated useful lives of the assets, generally three to five years, or the lease term, if applicable. Gains and losses upon asset disposal are taken into Other Income (Expense) in the quarter of disposition. Maintenance and repairs are charged to operations as incurred.

Long-lived assets, such as property and equipment and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimate discounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated fair value, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

Goodwill

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets (SFAS No. 142), goodwill is no longer subject to amortization, but rather is subject to at least an annual

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assessment for impairment.

Income taxes

Deferred tax assets and liabilities are determined based on the differences between financial reporting and tax basis of assets and liabilities, measured at tax rates that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized. As of December 31, 2003, the Company had recorded a full valuation allowance against its deferred tax assets.

Recent accounting pronouncements

In November 2002, the EITF reached consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF 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 adoption of EITF 00-21 did not have a material impact upon our financial position, cash flows or results of operations.

In May 2003, the FASB issue SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS No. 150). SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted. The adoption of SFAS No. 150 did not have a material impact upon our financial position, cash flows or results of operations.

In December 2003, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB 104 revises and rescinds portions of the previously issued revenue recognition guidance under SAB 101, Revenue Recognition and Emerging Task Force (EITF) Issue No. 00-21, Revenue Arrangements with Multiple Deliverables . The adoption of SAB 104 did not have a material effect on the Company s results of operations or financial condition.

Note 3. Stock-Based Compensation

SFAS No. 123, Accounting for Stock-Based Compensation (FSAS No. 123), as amended by SFAS No. 148, permits companies to measure the compensation cost of stock-based awards based on either their intrinsic value or their estimated fair value at the date of grant and recognize the amount over the related service period. Therefore, as permitted by SFAS No. 123 and SFAS No. 148, the Company accounts for its employee stock option plans under the intrinsic value method, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations. As such, compensation expense related to the granting of employee stock options is recorded over the vesting period only if, on the date of grant, the fair value of the underlying stock exceeds the option s exercise price. Digital Impact has adopted the disclosure-only requirements of SFAS No. 123, which allows entities to continue to apply the provisions of APB No. 25 for transactions with employees and provide pro forma net income and pro forma earnings per share disclosures for employee stock grants made as if the fair value based method of accounting in SFAS No. 123 had been applied to these transactions.

Had the Company determined compensation expense of employee stock options based on the estimated fair value of the stock options at the grant date, consistent with the guidelines of SFAS No. 123, the net income or loss would have been the pro forma amounts indicated below (in thousands, except per share amounts):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	2002	2003	2002
Net income (loss), as reported	$ 489	$ (297)	$ 304	$ (2,653)
Add: Stock-based employee compensation expense included in reported net loss	36	15	78	443
Deduct: total stock-based compensation determined under fair value based method for all awards	(737)	(702)	(1,442)	(2,642)

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	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	2002	2003	2002
Pro forma net loss, fair value method for all stock-based awards	$ (212)	$ (984)	$ (1,060)	$ (4,852)
Basic net income (loss) per share:				
As reported	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)
Pro forma	$ (0.01)	$ (0.03)	$ (0.03)	$ (0.16)
Diluted net income (loss) per share:				
As reported	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)
Pro forma	$ (0.01)	$ (0.03)	$ (0.03)	$ (0.16)

The fair value for each option granted was estimated at the date of grant using the Black-Scholes option-pricing model, assuming no expected dividends and the following assumptions:

	Stock Options			
	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	2002	2003	2002
Expected volatility	70%	90%	75%	90%
Weighted average risk-free interest rate	3.23%	2.99%	3.13%	4.10%
Expected life	4 years	6.5 years	4 to 6.5 years	6.5 years
Expected dividends	0%	0%	0%	0%

	Employee Stock Purchase Plan			
	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	2002	2003	2002
Expected volatility	70%	90%	87%	90%
Weighted average risk-free interest rate	1.2%	1.96%	1.28%	2.11%
Expected life	.75 years	.75 years	.75 years	.75 years
Expected dividends	0%	0%	0%	0%

The weighted average fair value per share of options granted at fair market value for the three and nine months ended December 31, 2003 was $1.39 and $1.39, respectively, and the weighted average fair value per share of options granted at fair market value for the three and nine months ended December 31, 2002 was $1.19 and $1.41, respectively.

The pro forma impact of options on the net income (loss) for the three and nine months ended December 31, 2003 and 2002, may not be representative of the effects on net income (loss) for future years, as future years will include the effects of additional years of stock option grants.

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Note 4. Net Income (Loss) Per Share Computation

Basic net income (loss) per common share excludes the effect of potentially dilutive securities and is computed by dividing the net income (loss) available to common shareholders by the weighted-average number of common shares outstanding for the reporting period. Diluted net income (loss) per share adjusts this calculation to reflect the impact of outstanding stock options and shares subject to repurchase to the extent that their inclusion would have a dilutive effect on net income (loss) per share for the reporting period. The following is a reconciliation of the numerator and denominators used in the basic and diluted net income (loss) per share amounts (in thousands, except per share amounts):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	2002	2003	2002
Numerator:				
Numerator for basic and diluted per share amounts - net income (loss)	$ 489	$ (297)	$ 304	$ (2,653)
Denominator:				
Denominator for basic net income (loss) per share weighted average shares	33,490	30,510	32,650	30,050
Effect of dilutive securities: stock options and shares subject to repurchase	2,532		2,543	
Denominator for diluted net income (loss) per share	36,022	30,510	35,193	30,050
Basic net income (loss) per share	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)
Diluted net income (loss) per share	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)

For the three month period ended December 31, 2003, approximately 1.1 million outstanding, out-of-the-money stock options were not included in the computation of diluted net income per share because to do so would have an antidilutive effect for the period. For the nine month period ended December 31, 2003, approximately 2.1 million outstanding options were not included in the computation of diluted net loss per share because to do so would have an antidilutive effect for the period. For each of the three and nine months ended December 31, 2002, approximately 8.0 million outstanding options, and 270,000 shares subject to repurchase were not included in the computation of diluted net loss per share because to do so would have an antidilutive effect for the periods.

Note 5. Intangible Assets

Intangible assets consist of the following (in thousands):

	December 31, 2003	March 31, 2003
Purchased technology	$ 1,930	$ 1,930
Accumulated amortization	(1,930)	(1,716)
	$	$ 214

Amortization expense was $161,000 for the three months ended December 31, 2002. Amortization expense was $214,000 and $483,000 for the nine months ended December 31, 2003 and 2002, respectively. Intangible assets were fully amortized as of September 30, 2003.

Note 6. Restructuring Charges

As a result of a cost reduction program initiated by the Company in the fiscal quarter ended March 31, 2003, we recorded net restructuring charges of $546,000, which were classified as operating expenses. This involved the involuntary termination of 18 employees, as well as charges for excess real estate related to the closure of our Cupertino facility.

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During the first nine months of fiscal 2004, no such charges were recorded.

In calculating the restructuring charge associated with future lease commitments we consulted with a third party real estate firm to determine reasonable estimates of future sublease income for our idle space, and to determine the time necessary to identify sublessees. The analysis was performed based on the current real estate market in the Silicon Valley area. Digital Impact s restructuring charge related to future lease commitments is based on a review of this information. The underlying lease commitment expires on March 31, 2004.

The following table sets forth a summary of the costs and related charges for Digital Impact s restructuring charges and the balance of restructuring reserves established (in thousands):

	Severance	Future Lease Costs	Total
Balance at March 31, 2003	$ 8	$ 350	$ 358
Cash expenditures	$ (8)	$ (262)	$ (270)
Balance at December 31, 2003	$	$ 88	$ 88

As of December 31, 2003, approximately $88,000 remains accrued in Accrued Liabilities and will be paid during the quarter ended March 31, 2004.

Note 7. 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 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. On February 19, 2003, the court granted in part and denied in part the omnibus motion to dismiss. The court s order did not dismiss any claims against the Company.

A proposal has been made for the settlement and release of claims against the issuer defendants, including the Company, in exchange for a guaranteed recovery to be paid by the issuer defendants insurance carriers and an assignment of certain claims. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. If the settlement does not occur, and litigation against the Company continues, the Company believes it has meritorious defenses and intends to defend the case vigorously.

On February 28, 2003, a related case, captioned *Liu v. Credit Suisse First Boston, et al.*, Case No. 03-20459, was filed in the United States District Court for the Southern District of Florida. The complaint names as defendants over forty companies and their respective directors and officers, including Digital Impact and two of its officers. The *Liu* plaintiff is not alleged to have bought or sold Digital Impact stock. The Company anticipates that this new case will be transferred to the United States District Court for the Southern District of New York and coordinated with the existing IPO-related litigation, discussed above. In June 2003, the plaintiffs in this action filed an amended complaint but did not rename the Company or its officers or directors.

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Note 8. Segment Reporting

Digital Impact is organized into two segments: Customer Marketing and Professional Services.

Customer Marketing provides clients with comprehensive solutions for creating and executing online direct marketing programs. The Company s solutions are designed to enable marketers to drive revenue and deepen customer relationships with a comprehensive process that includes: collecting and managing customer information, analyzing the information to determine ideal segments and offers, and sending highly relevant, individualized email messages.

Professional Services enable clients to enhance marketing programs and improve campaign results. Digital Impact offers clients services in each of the following categories: Strategy, Analysis, Data Management, Solutions Engineering, Web Development, Creative and Customer Acquisition.

The respective revenue and gross profit of each of these segments is as follows (in thousands):

	Three Months Ended December 31, 2003			Three Months Ended December 31, 2002		
	Customer Marketing	Professional Services	Total	Customer Marketing	Professional Services	Total
Revenues	$8,364	$3,145	$11,509	$8,467	$3,023	$11,490
Segment Gross Profit	$5,092	$1,496	$ 6,588	$5,652	$1,302	$ 6,954
Gross Margin	61%	48%	57%	67%	43%	61%

	Nine Months Ended December 31, 2003			Nine Months Ended December 31, 2002		
	Customer Marketing	Professional Services	Total	Customer Marketing	Professional Services	Total
Revenues	$23,669	$9,692	$33,361	$23,594	$9,542	$33,136
Segment Gross Profit	$14,196	$4,721	$18,917	$15,134	$4,611	$19,745
Gross Margin	60%	49%	57%	64%	48%	60%

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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 26. 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 world class services.

We derive our 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 and additional services provided by our Professional Services organization, including the development and execution of Customer Acquisition programs. Revenue for direct marketing and acquisition campaigns are recognized when persuasive evidence of an arrangement exists, the campaign has been sent, the fee is fixed or determinable and collection of the resulting receivables is reasonably assured. Revenue generated by our Professional Service organization is typically recognized as the service is provided.

As of December 31, 2003, the Company had 268 employees.

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, including those related to the allowance for doubtful accounts, intangible assets, restructuring costs and contingencies and litigation. Management bases its estimates 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 that 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;
- restructuring charges;
- accounting for internal-use software;
- estimating valuation allowances, specifically the allowance for doubtful accounts;
- valuation of long-lived assets and goodwill; and
- accounting for stock-based compensation.

Revenue recognition. We generate revenue from the sale of solutions that enable businesses to proactively communicate with their customers online.

Digital Impact applies the provisions of Staff Accounting Bulletin 104 Revenue Recognition and recognizes revenue when persuasive evidence of an arrangement 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 upon

sending 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 providers. Customer Acquisition programs fall into two general categories: List Rental 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 or email address matching service. 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 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 and ProspectNet programs. Digital Impact accounts for revenues and costs associated with Customer Acquisition programs in accordance with Emerging Issues Task Force Issue No. 99-19 (EITF 99-19), Reporting Revenue Gross as a Principal versus Net as an Agent. The cost of Customer Acquisition campaigns are estimated using Company records of outstanding purchase commitments when final vendor invoices have not been received. The cost of Customer Acquisition campaigns are recognized in the period that the programs are executed and are netted against program revenue.

Digital Impact recognizes revenue net of third-party costs because the majority of client and supplier contracts have the following characteristics: the supplier, not the Company, is the primary obligor in the arrangement, the Company has limited latitude in establishing the price charged to the client, the Company s credit risk is sometimes mitigated by receiving prepayment or reduced credit terms from its clients before ordering from the supplier, the Company does not maintain any inventory related to Customer Acquisition programs, the Company does not make changes to any data acquired from the supplier, and the client approves the supplier selection and the service specifications.

Digital Impact provides other complementary services to clients, such as strategy, solutions engineering, web-page development, creative design and data analytics. These services are typically billed on an hourly rate. The revenue for engagements that support the delivery of future products and services, such as custom solutions, 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 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 the customers financial position and ultimately their ability to pay according to the original 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 reasonably assured, then revenue is recognized on a cash-collected basis.

Restructuring charges. Digital Impact s restructuring reserve is related to our facilities in Cupertino. In calculating the restructuring charge we consulted with a third-party real estate firm to determine reasonable estimates of future sublease income for our idle space, and to determine the time necessary to identify sublessees. The analysis was performed based on the current real estate market in the Silicon Valley area. Digital Impact s restructuring charge related to future lease commitments is based on a review of this information. Should market conditions change, this information may be updated.

Accounting for internal-use software. We account for internal-use software in accordance with AICPA Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Internal-use software costs, including any fees paid to third parties to implement the software, are capitalized beginning when we have determined various factors are present, including among others, that the technology exists to achieve the performance requirements, we have made a decision as to whether we will purchase the software or develop it internally and we have authorized funding for the project. Capitalization of software costs ceases when the software implementation is substantially complete and is ready for its intended use, and the capitalized costs are amortized over the software s estimated useful life (generally one to two years) using the straight-line method. The estimated useful life is based on technical and marketing management judgment as to the product or feature life cycle. For the nine months ended December 31, 2003, we capitalized $278,000 related to internal-use software costs, none of which has been subject to amortization based upon deployment dates of the related projects.

When events or circumstances indicate the carrying value of internal use software might not be recoverable, we assess the recoverability of these assets by determining whether the amortization of the asset balance over its remaining life can be recovered through undiscounted future operating cash flows. The amount of impairment, if any, is recognized to the extent that the carrying value exceeds the projected discounted future operating cash flows and is recognized as a write down of the asset. In addition, if it is no longer probable that computer software being developed will be placed

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in service, the asset will be adjusted to the lower of its carrying value or fair value, if any, less direct selling costs. Any such adjustment would result in an expense in the period recorded, which could have a material adverse effect on our Consolidated Statement of Operations. As of December 31, 2003, we believe that no such impairment of internal-use software existed.

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 account disputes, 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 $7.9 million, net of allowance for doubtful accounts of $265,000, as of December 31, 2003.

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 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 or 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. Long-lived assets and goodwill amounted to $9.1 million as of December 31, 2003.

Accounting for Stock-Based Compensation

The Company accounts for stock-based awards to employees and directors using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Under the intrinsic value method, because the exercise price of the Company s employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized in the Company s Consolidated Statement of Operations. We believe this method is appropriate for the Company because it avoids the volatility of other expense methods which determine stock compensation expense typically by using the Black-Scholes option pricing model which was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models require input of highly subjective assumptions including the expected stock price volatility.

We have currently elected to apply the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation. In accordance with the provisions of SFAS No. 123, the Company applies APB No. 25, and related interpretations in accounting for its stock option plans.

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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,			
	2003		2002	
Net Revenue:				
Customer marketing	$ 8,364	73%	$ 8,467	74%
Professional services	3,145	27%	3,023	26%
Total net revenue	11,509	100%	$11,490	100%
Cost of revenue:				
Customer marketing	3,272	28%	2,815	24%
Professional services	1,649	14%	1,721	15%
Cost of revenue	4,921	43%	4,536	39%
Gross profit	6,588	57%	6,954	61%
Operating expenses:				
Research and development	1,118	10%	1,722	15%
Sales and marketing	3,055	27%	3,486	30%
General and administrative	1,943	17%	1,824	16%
Stock-based compensation	36	0%	15	0%
Amortization of purchased intangibles		0%	161	2%
Total operating expenses	6,152	54%	7,208	63%
Income (loss) from operations	436	4%	(254)	(2%)
Other income and (expense), net	53	0%	(43)	1%
Net income (loss)	$ 489	4%	$ (297)	(3%)

Three Months Ended December 31, 2003 and 2002

Revenues

Our Customer Marketing business provides clients with comprehensive solutions for creating and executing online direct marketing programs. Our solutions are designed to enable marketers to drive revenue and deepen customer relationships with a comprehensive process that includes: collecting and managing customer information, analyzing the information to determine ideal segments and offers, and sending highly relevant, individualized email messages. Customer Marketing revenues decreased 1% to $8.4 million or 73% of total revenue for the three months ended December 31, 2003 from $8.5 million or 74% of total revenue for the three months ended December 31, 2002.

The Professional Services group provides expertise to enhance marketing programs and improve results. Digital Impact offers clients services in each of the following categories: Strategy, Analysis, Data Management, Solutions Engineering, Web Development, Creative and Customer Acquisition. Professional Services revenues increased by 4% to $3.1 million, or 27% of total revenue, for the three months ended December 31, 2003 from $3.0 million, or 26% of total revenue, for the three months ended December 31, 2002.

Total revenues were unchanged at $11.5 million for both the three months ended December 31, 2003 and December 31, 2002. Higher Professional Services revenue, primarily related to Solutions Engineering revenue, was offset by lower Campaign Management revenue, where higher email volume was offset by price erosion over the twelve-month period.

For the fiscal year ending March 31, 2004, we expect revenue to be approximately equal to the prior fiscal year s net revenue.

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Cost of Revenues.

Cost of revenue consists primarily of expenses relating to the delivery of online direct marketing services, including personnel costs of our services staff, the depreciation and amortization of equipment, purchased and licensed technology, and data center expenses.

Total cost of revenues increased 8% to $4.9 million for the three months ended December 31, 2003 from $4.5 million for the three months ended December 31, 2002.

The increase in cost of revenues was primarily related to a $187,000 increase in depreciation expense and amortization of maintenance contracts related to the expansion of our data center infrastructure and a $180,000 increase in personnel and consulting expenses.

Gross margin decreased to 57% for the three months ended December 31, 2003 from 61% for the three months ended December 31, 2002. The decrease was largely due to the impact of price erosion on Customer Marketing revenues.

Gross margin for Customer Marketing was 61% and 67% for the three months ended December 31, 2003 and 2002, respectively. The decrease in gross margin is primarily the result of price erosion and volume discounts partially offset by increased data center capacity utilization as email volume increased by 23%.

Gross margin for Professional Services was 48% and 43% for the three months ended December 31, 2003 and 2002, respectively. The increase in Professional Services gross margin was related to higher utilization rates for personnel supporting Solutions Engineering and Creative projects.

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 allocate the total cost of facilities and IT to each of the functional areas based on each area s relative headcount. These allocated charges include rent and other facilities related costs, communications expenses, depreciation of furniture and office equipment and related support staff salaries.

Research and Development. Research and development expenses consist primarily of personnel related costs, outside contractor costs, and software and hardware maintenance costs. Research and development expenses declined by 35% to $1.1 million for the quarter ended December 31, 2003 from $1.7 million for the quarter ended December 31, 2002. The decline is primarily a result of a $330,000 reduction in personnel and allocated expenses related to the reduction in our engineering and contractor staff, the capitalization of $102,000 internal-use software and a $250,000 reduction in the amortization of maintenance contracts. We capitalized $102,000 for internally developed software for the three months ended December 31, 2003, no internally developed software was capitalized for the three months ended December 31, 2002. During the fiscal year ending March 31, 2004, we expect research and development expense to decrease in absolute dollars and to decrease as a percentage of revenue from the prior fiscal year. Research and development expense is substantially dependent on the level of development activity and related staffing.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs of our direct sales force, senior account management and marketing staff and marketing expenses for trade shows, promotional activities and media events. Sales and marketing expenses decreased 12% to $3.1 million for the three months ended December 31, 2003 from $3.5 million for the three months ended December 31, 2002. The decrease was primarily due to a $526,000 decline in personnel costs, allocated expenses, and commissions, offset by a $40,000 increase in travel and entertainment expenses. During the fiscal year ending March 31, 2004, we expect sales and marketing expenses to decrease in absolute dollars from fiscal 2003 and to decline as a percentage of revenue.

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General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate operations, including corporate management, information technology services, finance, accounting, human resources and legal functions. General and administrative expenses increased 7% to $1.9 million for the three months ended December 31, 2003, from $1.8 million for the three months ended December 31, 2002. The increase was primarily the result of higher recruiting expenses. During the fiscal year ending March 31, 2004, we expect general and administrative expenses to increase slightly in absolute dollars from fiscal 2003 and to decline as a percentage of revenue.

Amortization of Purchased Intangibles. Amortization of purchased intangibles consists of the amortization of purchased technology from our July 2000 acquisition of MineShare. Amortization of purchased intangibles was $161,000 for the three months ended December 31, 2002. As of September 30, 2003 all purchased intangibles have been fully amortized.

Other Income and (expense). Other income and (expense) was $53,000 for the three months ended December 31, 2003, compared to ($43,000) for the three months ended December 31, 2002. Other expenses relate primarily to interest paid on leases and debt and losses on disposals of fixed assets. Other income relates to interest income on cash, cash equivalents and short-term investments. For the three months ended December 31, 2003 we recorded a $25,000 gain on the currency translation of short-term intercompany receivables.

Income taxes. No provision for federal and state income taxes was recorded as we incurred net operating losses from inception through December 31, 2003. Due to the uncertainty regarding the ultimate utilization of the net operating loss carryforwards, we have not recorded any benefit for losses and a valuation allowance has been recorded for the entire amount of the net deferred tax asset. The Tax Reform Act of 1986 limits the use of net operating loss and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. If we should have an ownership change, as defined for tax purposes, utilization of the carryforwards could be restricted. In addition, sales of our stock, including shares sold in the initial public offering, may further restrict our ability to utilize our net operating loss carryforwards.

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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.

	Nine Months Ended December 31,			
	2003		2002	
Net Revenue:				
Customer marketing	$23,669	71%	$23,594	71%
Professional services	9,692	29%	9,542	29%
Total net revenue	33,361	100%	$33,136	100%
Cost of revenue:				
Customer marketing	9,473	28%	8,460	25%
Professional services	4,971	15%	4,931	15%
Cost of revenue	14,444	43%	13,391	40%
Gross profit	18,917	57%	19,745	60%
Operating expenses:				
Research and development	3,840	12%	5,440	17%
Sales and marketing	9,033	27%	10,493	32%
General and administrative	5,381	16%	5,424	16%
Stock-based compensation	78	0%	443	1%
Amortization of purchased intangibles	214	1%	483	2%
Total operating expenses	18,546	56%	22,283	68%
Income (loss) from operations	371	1%	(2,538)	(8%)
Other income and (expense), net	(67)	0%	(115)	(0%)
Net income (loss)	$ 304	1%	$ (2,653)	(8%)

Nine Months Ended December 31, 2003 and 2002

Revenues

Customer Marketing revenues increased slightly to $23.7 million for the nine months ended December 31, 2003 from $23.6 million or the nine months ended December 31, 2002. Customer Marketing represented 71% of total revenue for each of the nine months ended December 31, 2003 and 2002.

Professional Services revenues increased 2% to $9.7 million for the nine months ended December 31, 2003 from $9.5 million for the nine months ended December 31, 2002. Professional Services represented 29% of total revenue for each of the nine months ended December 31, 2003 and 2002.

Total revenues increased slightly to $33.4 million for the nine months ended December 31, 2003 from $33.1 million for the nine months ended December 31, 2002. The increase was the result of a 26% increase in email volume, largely offset by price erosion over the twelve-month period.

Cost of Revenues

Total cost of revenues increased 8% to $14.4 million for the nine months ended December 31, 2003 from $13.4 million for the nine months ended December 31, 2002.

The increase in costs of revenues was primarily related to a $835,000 increase in depreciation expense and amortization of maintenance contracts related to the expansion of our data center infrastructure and a $460,000 increase in service personnel costs and consulting expenses, offset by a $260,000 reduction in data center rent and a $90,000 reduction in the amortization of capitalized research and development.

Gross margin decreased to 57% for the nine months ended December 31, 2003 from 60% for the nine months ended December 31, 2002. The decrease was largely due to a decline in gross margin for Customer Marketing.

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Gross margin for Customer Marketing was 60% and 64% for the nine months ended December 31, 2003 and 2002, respectively. The decrease in gross margin is primarily the result of price erosion, offset by improvements in operational efficiency which resulted in a lower average cost per email.

Gross margin for Professional Services was 49% and 48% for the nine months ended December 31, 2003 and 2002, respectively. The increase in gross margin is primarily the result of higher utilization rates for our professional service personnel.

Operating Expenses.

Research and Development. Research and development expenses consist primarily of personnel related costs, outside contractor costs, and software and hardware maintenance costs. Research and development expenses declined by 29% to $3.8 million for the nine months ended December 31, 2003 from $5.4 million for the nine months ended December 31, 2002. The decline is primarily a result of a $1.2 million reduction in personnel and allocated expenses, related to a reduction in our engineering and contractor staffing and the capitalization of internal-use software and a $250,000 decline in the amortization of maintenance contracts where the renewal costs are borne by production costs. We capitalized $278,000 for internally developed software for the nine months ended December 31, 2003 compared to $92,000 from December 31, 2002. During the fiscal year ending March 31, 2004, we expect research and development expense to decrease in absolute dollars and to decrease as a percentage of revenue from the prior fiscal year. Research and development expense is substantially dependent on the level of development activity and related staffing.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs of our direct sales force, senior account management and marketing staff and marketing expenses for trade shows, advertisements, promotional activities and media events. Sales and marketing expenses decreased 14% to $9.0 million for the nine months ended December 31, 2003 from $10.5 million for the nine months ended December 31, 2002. The decrease was primarily due to a $1.7 million decline in personnel and allocated expenses, offset by a $200,000 increase in marketing, travel and entertainment, and professional development expenses During the fiscal year ending March 31, 2004, we expect sales and marketing expenses to decrease in absolute dollars from fiscal 2003 and to decline as a percentage of revenue.

General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate operations, including information technology services, finance, accounting, human resources, facilities and legal. General and administrative expenses were unchanged at $5.4 million for each the nine months ended December 31, 2003 and 2002.

Stock-based Compensation. Stock-based compensation, a non-cash expense, decreased 82% to $78,000 for the nine months ended December 31, 2003 from $443,000 for the nine months ended December 31, 2002. The decline was primarily due to our use of the accelerated method of amortization for our employee stock-based compensation arrangements plus the reversal of balances of unamortized stock-based compensation related to employee terminations.

As of December 31, 2003, approximately $19,000 of unearned stock-based compensation remains to be amortized.

Amortization of Purchased Intangibles. Amortization of purchased intangibles consists of the amortization of purchased technology from our July 2000 acquisition of MineShare. Amortization of purchased intangibles declined 56% to $214,000 for the nine months ended December 31, 2003 from $483,000 for the nine months ended December 31, 2002.

As of September 30, 2003, no purchased intangibles remain to be amortized.

Other Income and (expense). Other income and (expense) was ($67,000) for the nine months ended December 31, 2003, compared to ($115,000) for the nine months ended December 31, 2002. Other expenses relate primarily to interest paid on leases and debt and losses on disposals of fixed assets. Other income relates to interest income on cash, cash equivalents and short-term investments. For the nine months ended December 31, 2003 we incurred a loss on disposal of fixed assets of $78,000 and recorded a $25,000 gain on the translation of short-term intercompany receivables.

Income taxes. No provision for federal and state income taxes was recorded as we incurred net operating losses from inception through December 31, 2003. Due to the uncertainty regarding the ultimate utilization of the net operating loss carryforwards, we have not recorded any benefit for losses and a valuation allowance has been recorded for the entire amount of the net deferred tax asset. The Tax Reform Act of 1986 limits the use of net operating loss and tax

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credit carryforwards in certain situations where changes occur in the stock ownership of a company. If we should have an ownership change, as defined for tax purposes, utilization of the carryforwards could be restricted. In addition, sales of our stock, including shares sold in the initial public offering, may further restrict our ability to utilize our net operating loss carryforwards.

Liquidity and Capital Resources

As of December 31, 2003, we had $27.2 million in cash, cash equivalents and short-term investments and working capital of $28.9 million. In addition, as of December 31, 2003, we had $1.2 million in restricted cash supporting letters of credit issued against certain contractual lease obligations.

For the nine months ended December 31, 2003 our operating activities generated net cash of $3.9 million compared to $4.4 million for the nine months ended December 31, 2002. Net cash generated by operating activities for the nine months ended December 31, 2003 consisted of the net income of $304,000 and non-cash items of $4.1 million, offset by a $537,000 decrease in cash arising from changes in assets and liabilities, primarily as a result of decreases in accrued liabilities and payroll, partially offset by decrease in other assets and increases in accounts payable. Cash provided by operating activities for the nine months ended December 31, 2002 resulted from the net loss of $2.7 million, offset by non-cash items of $4.9 million, and changes in assets and liabilities that generated $2.2 million.

Our investing activities used net cash of $3.3 million for the nine months ended December 31, 2003 compared to $2.8 million used by investing activities for the nine months ended December 31, 2002. Net cash used in investing activities for the nine months ended December 31, 2003 related to acquisitions of property and equipment totaling $1.8 million and purchases of short-term investments totaling $1.5 million. Net cash used by investing activities for the nine months ended December 31, 2002 was attributable to acquisitions of equipment of approximately $4.2 million, offset by maturities of investments in marketable securities of $1.4 million.

For the nine months ended December 31, 2003, our financing activities provided net cash of $1.4 million compared to net cash used in financing activities of $1.7 million for the nine months ended December 31, 2002. Net cash provided by financing activities for the nine months ended December 31, 2003 consisted of proceeds from option exercises and employee stock plan purchases totaling $2.8 million, offset by principal payments on long-term debt of $1.3 million and purchases of treasury stock of $73,000. Net cash used by financing activities for the nine months ended December 31, 2002 was attributable primarily to payments on long-term debt and leases of $2.6 million, partially offset by proceeds from the exercise of stock options and the purchase of shares through our employee stock purchase plan of $929,000.

We are committed to making cash payments in the future on three types of contracts: notes payable, capital leases and non-cancelable operating leases. We have no off-balance sheet debt or other such unrecorded obligations and we have not guaranteed the debt of any other party. As of December 31, 2003 we had borrowings in the form of notes payable and capital leases totaling $589,000, payable in monthly installments through October 2005, with a weighted average interest rate of 9.9%. Our credit agreements place restrictions on our ability to pay dividends. 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, 2003, there was approximately $298,000 outstanding under this loan agreement.

Digital Impact has made certain commercial commitments that extend beyond our fiscal year ending March 31, 2004. These commitments include letters of credit obtained from a financial institution in lieu of a security deposit for leased office space. The aggregate amount of the letters of credit is classified as restricted cash and is stated separately on the balance sheet.

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Below is a schedule of the future payments that we are obligated to make based on agreements in place as of December 31, 2003:

	Total	Three Months Ended March 31, 2004	Year Ended March 31, 2005	2006	2007	2008
			(in thousands)			
Contractual Obligations:						
Notes payable	$ 589	$ 334	$ 255	$	$	$
Capital leases						
Operating leases	8,604	942	2,864	2,270	2,324	204
Total Contractual Obligations	$9,193	$1,276	$3,119	$2,270	$2,324	$204

We have commercial commitments under letters of credit that expire in amounts of $57,000 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. Our future cash flows and capital requirements depend on numerous factors, including market acceptance of our services, competition from new and existing competitors, the amount of resources we invest in our data center infrastructure and new product development, marketing and selling our products and services, our brand promotions and any future acquisitions or divestitures.

The Company s primary source of liquidity is $27.2 million in cash and cash equivalents, and short-term investments. The Company believes it has the necessary financial resources to fund its working capital needs, capital expenditures and other business requirements for at least the next 12 months.

Recent Accounting Pronouncements

In November 2002, the EITF reached consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF 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 does not believe that the adoption of this standard will have a material effect on its financial position or results of operations.

In May 2003, the FASB issue SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS No. 150). SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted. The Company does not expect the adoption of SFAS No. 150 to have a material impact upon our financial position, cash flows or results of operations.

In December 2003, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB 104 revises and rescinds portions of the previously issued revenue recognition guidance under SAB 101, Revenue Recognition and Emerging Task Force (EITF) Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. The adoption of SAB 104 did not have a material effect on the Company s results of operations or financial condition.

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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 derive our revenue from marketing services, which revenues tend to be cyclical and dependent on the economic prospects of our clients and the economy in general. A sustained reduction in expenditures by our clients or a sustained downturn in the economy could cause our revenues to decline significantly in any given period.

Our clients marketing and advertising expenditures tend to be cyclical, reflecting overall economic conditions as well as budgeting and buying patterns. The overall market for marketing and advertising services, including Internet marketing and advertising services, has been characterized in recent quarters by increasing softness of demand and lower prices. 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 our clients or the economy in general could alter pending priorities or increase the time it takes to close a sale with a prospective client. As a result, our revenues from marketing services may decline significantly in any given period.

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.

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

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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 two clients each accounted for more than 10% of our revenues for the three and nine months ended December 31, 2003, the loss of one of these clients 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, Silverpop, Bigfoot Interactive, eDialog and InfoUSA, as well as the in-house information technology departments of our existing and prospective clients. The loss of a client due to service quality or technology problems could result in reputational harm to us and, as a result, increase the effect of competition and negatively impact our ability to attract new 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 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

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AOL. We do not have, nor are we required to have, an agreement with AOL to deliver emails to their customers. AOL 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, AOL and other Internet service providers are able to block messages from reaching their users. Recent releases of Internet service provider software and the implementation of stringent new policies by Internet service providers have caused periodic temporary blockages of our ability to successfully deliver emails to their customers. 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. In addition, the effectiveness of email marketing may decrease as a result of increased consumer resistance to email marketing in general.

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 or if third parties develop superior intellectual property, third parties could use our intellectual property without our consent and prevent us from using their technology.

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, as well as contractual obligations. We have one issued U.S. patent and have three U.S. patent applications pending. We have several registered trademarks in the U.S. and Japan 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.

We are one of several companies rapidly building new technologies in our industry. It is possible that a third party could be awarded a patent that applies to some portion of our technology. If this occurs, we may be required to incur substantial legal fees, cease using the technology or pay significant licensing fees for such use.

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.

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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.

Congress recently enacted the CAN-SPAM Act of 2003, legislation that regulates the sending of commercial email. This legislation pre-empts state laws regulating commercial email. The effect of this legislation on marketers is difficult to predict. We cannot assure you that this or future legislation regarding commercial email will not harm our business. Moreover, list rental and other types of affiliate marketing programs must be modified to comply with certain aspects of CAN-SPAM. Some of these modifications may add to the cost of conducting these types of programs. As a result, there may be a decline in our Customer Acquisition revenues. For the three and nine months ended Dec 31, 2003, these programs represented 3% and 2% of total revenue, respectively.

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

Interest Rate Risk

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 our outstanding debt instruments. The risk associated with fluctuating interest expense is limited, however, to the exposure related to those debt instruments and credit facilities 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.

Foreign Currency Risk

For the period from our inception through December 31, 2003, we provided our services to clients primarily in the United States. As a result, our financial results have not been materially 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, to date, has had minimal operations and minimal foreign currency sales. The effect of foreign exchange rates fluctuations on operations were not material for the nine months ended December 31, 2003 and 2002.

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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. As of December 31, 2003, we had $118,000 in cash and cash equivalents denominated in foreign currencies.

Item 4. Controls and Procedures

As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company s disclosure controls and procedures are effective, as of the end of the period covered by this report, to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. There was no change in the Company s internal control over financial reporting during the Company s most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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. On February 19, 2003, the court granted in part and denied in part the omnibus motion to dismiss. The court s order did not dismiss any claims against the Company.

A proposal has been made for the settlement and release of claims against the issuer defendants, including the Company, in exchange for a guaranteed recovery to be paid by the issuer defendants insurance carriers and an assignment of certain claims. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. If the settlement does not occur, and litigation against the Company continues, the Company believes it has meritorious defenses and intends to defend the case vigorously.

On February 28, 2003, a related case, captioned *Liu v. Credit Suisse First Boston, et al.*, Case No. 03-20459, was filed in the United States District Court for the Southern District of Florida. The complaint names as defendants over forty companies and their respective directors and officers, including Digital Impact and two of its officers. The *Liu* plaintiff is not alleged to have bought or sold Digital Impact stock. The Company anticipates that this new case will be transferred to the United States District Court for the Southern District of New York and coordinated with the existing IPO-related litigation, discussed above. In June 2003, the plaintiffs in this action filed an amended complaint but did not rename the Company or its officers or directors.

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.

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Item 5. Other Information

Not applicable.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a) Exhibits

Exhibit No.	Description
31.1	Certification Pursuant to Rule 13a or 15d-14 of the Securities and Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by the Principal Executive Officer, filed herewith.
31.2	Certification Pursuant to Rule 13a or 15d-14 of the Securities and Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer, filed herewith.
32.1	Statement Required by 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by Principal Executive Officer, furnished herewith.
32.2	Statement Required by 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by Chief Financial Officer, furnished herewith.

b) Reports on Form 8-K

On October 23, 2003, Digital Impact furnished a Current Report on Form 8-K with the Securities and Exchange Commission announcing our financial results for our second fiscal quarter ended September 30, 2003.

On January 8, 2004, the Company furnished a Current Report on Form 8-K with the Securities and Exchange Commission. The Current Report on Form 8-K includes a copy of our press release dated January 5, 2004, which reaffirmed our quarterly financial forecasts for the quarter ended December 31, 2003.

On January 27, 2004, the Company furnished a Current Report on Form 8-K with the Securities and Exchange Commission. The Current Report on Form 8-K includes a copy of our press release dated January 27, 2004 reporting our results of operations and financial condition for the quarter ended December 31, 2003.

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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 11, 2004

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)

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