

DIGITAL IMPACT INC /DE/

Form 10-Q

November 12, 2004

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2004

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

(State or other jurisdiction of incorporation or organization)

94-3286913

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

177 Bovet Road, San Mateo, California

(Address of principal executive offices)

94402

(Zip Code)

Registrant's telephone number, including area code: (650) 356-3400

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

None

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

Common Stock, \$0.001 par value

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

Yes

No

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

Exchange Act of 1934:

Yes

No

As of November 10, 2004, there were approximately 35.3 million shares of the Registrant's Common Stock outstanding.

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CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Revenues	\$10,235	\$10,924	\$20,646	\$21,852
Cost of revenues	5,706	4,792	10,841	9,741
Gross profit	4,529	6,132	9,805	12,111
Operating expenses:				
Research and development	845	1,290	1,829	2,744
Sales and marketing	3,827	2,914	7,211	5,965
General and administrative	1,888	1,754	3,708	3,467
Total operating expenses	6,560	5,958	12,748	12,176
Income (loss) from operations	(2,031)	174	(2,943)	(65)
Other income and (expense), net	16	(66)	44	(120)
Net income (loss)	\$ (2,015)	\$ 108	\$ (2,899)	\$ (185)
Basic net income (loss) per share	\$ (0.06)	\$ 0.00	\$ (0.08)	\$ (0.01)
Weighted average shares used in basic net income (loss) per share	34,650	32,780	34,460	32,240
Diluted net income (loss) per share	\$ (0.06)	\$ 0.00	\$ (0.08)	\$ (0.01)
	34,650	35,662	34,460	32,240

Weighted average shares used in
diluted net income (loss) per share

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

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DIGITAL IMPACT, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	September 30, 2004	March 31, 2004
	<hr/>	<hr/>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 23,813	\$ 25,550
Short-term investments	108	608
Accounts receivable, net	8,190	8,172
Prepaid expenses and other current assets	1,120	1,385
	<hr/>	<hr/>
Total current assets	33,231	35,715
	<hr/>	<hr/>
Property and equipment, net	5,024	6,100
Restricted cash	1,164	1,164
Goodwill	4,087	2,002
Intangible assets, net	286	
Other assets	361	380
	<hr/>	<hr/>
Total assets	\$ 44,153	\$ 45,361
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS		
EQUITY		
Current liabilities:		
Accounts payable	\$ 996	\$ 1,100
Accrued payroll	1,642	1,647
Accrued pass-through vendor costs	1,229	659
Accrued liabilities	763	614
Deferred revenues	1,383	2,087
Current portion of long-term debt	335	158
	<hr/>	<hr/>
Total current liabilities	6,348	6,265
	<hr/>	<hr/>
Long-term debt, less current portion	89	80
	<hr/>	<hr/>
Total liabilities	6,437	6,345
	<hr/>	<hr/>

Stockholders' equity:		
Preferred Stock		
Common Stock	35	34
Additional paid-in capital	148,259	145,540
Accumulated other comprehensive income	48	51
Unearned stock-based compensation	(935)	(6)
Accumulated deficit	(108,858)	(105,959)
Less treasury stock, at cost	(833)	(644)
	<u> </u>	<u> </u>
Total stockholders' equity	<u>37,716</u>	<u>39,016</u>
Total liabilities and stockholders' equity	<u>\$ 44,153</u>	<u>\$ 45,361</u>

The accompanying notes are an integral part of these unaudited 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 September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Net income (loss)	\$(2,015)	\$108	\$(2,899)	\$(185)
Other comprehensive loss: Cumulative translation adjustment		(7)	(3)	(67)
Net changes in comprehensive income (loss)		(7)	(3)	(67)
Comprehensive income (loss)	\$(2,015)	\$101	\$(2,902)	\$(252)

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

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DIGITAL IMPACT, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended September 30,	
	2004	2003
Cash flows from operating activities		
Net loss	\$ (2,899)	\$ (185)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,261	2,926
Recovery of bad debts		(70)
Stock-based compensation	552	42
Loss on disposal of fixed assets and other non-cash items	25	
Changes in operating assets and liabilities:		
Accounts receivable	231	(1,209)
Prepaid expenses and other current assets	475	(351)
Restricted cash		(49)
Other assets	23	86
Accounts payable	(260)	(192)
Accrued liabilities and accrued payroll	398	(865)
Deferred revenue	(704)	(52)
	102	81
Net cash provided by operating activities		
Cash flows from investing activities		
Purchases of investments in marketable securities		(1,495)
Maturities of investments in marketable securities	500	
Acquisition of Marketleap, net of cash acquired	(1,548)	
Proceeds from sales of equipment	8	
Acquisition of property and equipment	(871)	(1,052)
	(1,911)	(2,547)
Net cash used in investing activities		
Cash flows from financing activities		
Principal payments on long-term debt and capital lease obligations	(295)	(896)
Proceeds from issuance of common stock	558	2,191
Purchases of treasury stock	(189)	(39)
	(295)	(896)

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Net cash provided by financing activities	74	1,256
	<u> </u>	<u> </u>
Effect of exchange rates on cash and cash equivalents	(2)	9
Net decrease in cash and cash equivalents	(1,737)	(1,201)
Cash and cash equivalents at beginning of period	25,550	23,659
	<u> </u>	<u> </u>
Cash and cash equivalents at end of period	\$23,813	\$22,458
	<u> </u>	<u> </u>
Supplemental non-cash information:		
Unearned stock-based compensation cancellations	\$	\$ (37)

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

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**DIGITAL IMPACT, INC.
NOTES TO 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 a leading provider of integrated digital marketing solutions for Global 2000 enterprises. The Company draws on its industry specific expertise, its comprehensive methodology for creating programs to address specific marketing objectives and its proprietary technology platform to deliver marketing campaigns through email as well as website, search and other media.

Digital Impact derives its revenues from the sale of solutions that enable businesses to proactively communicate with its 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 Agency Services organization.

Digital Impact is organized into two segments: Email Marketing and Agency Services. Email 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 delivering highly relevant, individualized email messages. Agency Services are utilized by clients to enhance marketing programs and improve results. Digital Impact offers clients services in each of the following categories: Strategic Marketing, Search and Acquisition Services, Creative Services, Web Development, Data Management, Measurement and Analytics, Program Delivery and Campaign Automation.

On July 12, 2004, the Company acquired all of the outstanding equity of Marketleap.com, Inc. Total consideration for the acquisition of Marketleap was approximately \$3.8 million, consisting of 1.3 million shares of stock and stock options and \$1.5 million in cash.

Note 2. Summary of Significant Accounting Policies

Basis of presentation and liquidity

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

The accompanying interim consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. The accompanying interim 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 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, 2004.

Certain reclassifications have been made to the prior years' consolidated financial statements to conform to the current year's presentation. The reclassifications had no effect on prior years' stockholders' equity or net loss.

The Company incurred a net loss of approximately \$2.0 million and \$2.9 million for the three and six months ended September 30, 2004, respectively. The Company generated net income of \$108,000 for the three months ended September 30, 2003 and incurred a net loss of \$185,000 for the six months ended September 30, 2003. The Company generated cash of \$102,000 from operating activities for the six months ended September 30, 2004, compared to \$81,000 provided by operating activities for the six months ended September 30, 2003.

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.

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The Company's primary source of liquidity is \$23.8 million in cash and cash equivalents, and \$108,000 in short-term investments. On October 1, 2004, Digital Impact entered into a Loan and Security Agreement with Silicon Valley Bank that provides for an \$8.0 million revolving line of credit. As of September 30, 2004, there have been no borrowings on the loan. 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.

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 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 U.K. Pound. Assets and liabilities are translated using the exchange rate at the balance sheet date. Revenues, expenses, gains, and losses are translated using the average exchange rate for the month in which the transaction occurred. Translation gains and losses are recorded in accumulated other comprehensive income as a separate component of stockholders' equity. Net gains and losses from foreign currency transactions are included in the 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. Email 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, which are part of Agency Services revenues, are derived primarily from programs that assist clients in growing their email lists and generating leads through the use of third-party providers. Customer Acquisition programs fall into three general categories: List Rental, Co-registration and search engine marketing 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. Co-registration 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. Search engine marketing involves the expert management of search, placement, traffic flow, and analytical data for our clients. Digital Impact contracts with third-party providers to deliver names of individuals who opt-in to join the client's email list or, in the case of search, to deliver specific content in response to user search queries. Digital Impact is obligated to make payments to third parties for the cost of services associated with the execution of List Rental, Co-registration and search engine marketing 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: most of the time, the supplier, not the Company, is the primary obligor in the arrangement, 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, 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, and the client approves the supplier selection and the service specifications.

Digital Impact provides other complementary services to clients, which are also part of our Agency Services revenues, such as strategic marketing, campaign automation, web-page development, creative services, data management, measurement and analytics and program delivery. These services are typically billed on an hourly or project basis. The revenue for engagements that support the delivery of future products and services is deferred at the time of delivery and recognized pro-rata over the future periods of usage. The period over which the revenue is

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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 maturity, or remaining maturity at the time of purchase, of three months or less 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 or losses from the sale of short-term investments.

Concentration of credit risk and other risks and uncertainties

Financial instruments and assets subjecting the Company to concentration of credit risk consist primarily of cash and cash equivalents, short-term investments and trade accounts receivable. The Company's cash and cash equivalents are maintained at major U.S. financial institutions. Deposits in these institutions 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 six months ended September 30, 2004, two customers each represented 11% of revenue. For the six months ended September 30, 2003 two customers represented 13% and 11% of revenue, respectively. As of September 30, 2004, two customers represented 11% and 18% of accounts receivable, respectively. As of September 30, 2003, one customer represented 21% of accounts receivable.

Research and development expense

Research and development expenses consist primarily of salary and related personnel expense, consulting fees and other operating expenses related to the 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 six months ended September 30, 2004, the Company capitalized approximately \$38,000 in software development costs. These costs are being amortized using the straight-line method over the estimated useful life of the software, generally two years, beginning when the software is ready for use. These amounts are included in property and equipment in the accompanying consolidated balance sheet. For the six months ended September 30, 2004, the Company amortized approximately \$26,000 of software development costs.

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 year of disposition.

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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 estimated 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 in 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 and other intangible assets

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 assessment for impairment. The Company completed its annual impairment test in March 2004 and determined that no impairment existed.

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 September 30, 2004, the Company had recorded a full valuation allowance against its deferred tax assets.

Recent accounting pronouncements

In April 2004, the Emerging Issues Task Force issued Statement No. 03-06 Participating Securities and the Two-Class Method Under FASB Statement No. 128, Earnings Per Share (EITF 03-06). EITF 03-06 addresses a number of questions regarding the computation of earnings per share by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company when, and if, it declares dividends on its common stock. EITF 03-06 also provides further guidance in applying the two-class method of calculating earnings per share, clarifying what constitutes a participating security and how to apply the two-class method of computing earnings per share once it is determined that a security is participating, including how to allocate undistributed earnings to such a security. EITF 03-06 is effective for fiscal periods beginning after March 31, 2004. The Company has evaluated the effect of adopting EITF 03-06 and does not believe that it will have any effect on its results of operations or net income per share.

On March 31, 2004, the FASB issued a proposed Statement, Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95, that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or, liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The proposed statement would eliminate the ability to account for share-based compensation transactions using Accounting Principles Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees, and generally would require that such transactions be accounted for using a fair-value-based method and recognized as expenses in our consolidated statement of income. The proposed standard would require the modified prospective method be used, which would require that the fair value of new awards granted from the beginning of the year of adoption plus unvested awards at the date of adoption be expensed over the vesting period. In addition, the proposed statement encourages companies with adequate exercise history to use the binomial approach to value stock options, which differs from the Black-Scholes option pricing model that we currently use to determine the fair value of our options. The proposed standard is recommending that the effective date for public companies be fiscal periods

beginning after June 15, 2005. Should this proposed statement be finalized in its current form, it will have a significant impact on our consolidated statement of operations as we will be required to expense the fair value of our stock options rather than disclosing the impact on our consolidated net loss within our notes as is our current practice.

Note 3. Business Combination

On July 12, 2004, the Company acquired all of the outstanding equity of Marketleap.com, Inc. We expect that the combination of Digital Impact's strengths in email marketing with Marketleap's experience in search engine marketing will offer clients true integrated digital online marketing. Digital Impact expects to be able to assist clients in managing their customers through the entire lifecycle of awareness, consideration, purchase and loyalty, through a combination of email and search marketing strategy, analytics and campaign execution. These factors contributed to a purchase price in excess of the fair market value of the net tangible and intangible assets acquired from Marketleap, and as a result the Company has recorded goodwill in conjunction with this transaction. Total consideration for the acquisition of Marketleap was approximately \$3.8 million, consisting of 1.3 million shares of stock and stock options and \$1.7 million in cash, including \$205,000 in fees related to the acquisition. The acquisition was completed under purchase accounting and the purchase price has been allocated as follows:

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Goodwill of \$2.1 million;

Deferred stock compensation totaling \$1.4 million, which will be amortized over 2.5 years through cost of goods sold and operating expenses;

Intangible assets, consisting of \$191,000 and \$46,000 for existing customer base and trade-name, respectively, will be amortized through sales and marketing expenses over the next 3 years. Intangible assets, consisting of \$88,000 for developed technology, will be amortized through cost of goods sold over the next three years.

The amount allocated to the purchased intangibles was determined by management with the assistance of an appraisal completed by an independent third party using established valuation techniques. The valuation techniques included a fair value analysis of the acquired balance sheet components, a present value analysis of incremental operating income and incremental free cash flows, an analysis of avoided workforce recruiting and training costs, an analysis of avoided loss of productivity, an analysis of technology replacement cost, and a discounted cash flow analysis of acquired trademarks and URL.

The Company's results of operations are inclusive of Marketleap activities from July 13, 2004 to September 30, 2004. The impact of the acquisition on our second fiscal quarter was as follows:

Stock-based compensation charges totaled \$524,000. This expense is allocated to the appropriate categories in the statement of operations;

Amortization of intangibles totaled \$39,000, of which \$28,000 is recorded as sales and marketing expense and \$11,000 is recorded as cost of goods sold in the consolidated statement of operations;

\$1.7 million of cash was used for purchase consideration and deal related costs, and we received \$182,000 of cash in the purchased assets.

From the Marketleap acquisition, Digital Impact has a contractual obligation to pay up to 200,000 shares of Company's common stock if certain revenue goals are met. In the event that the revenues of the Company from its Search and Acquisition Services for the fiscal year ending March 31, 2005 are greater than \$4.4 million, but less than or equal to \$5.0 million, the earnout shares payable to Marketleap stock and option holders will equal 100,000 shares of Company's common stock. In the event that the revenues of the Company from its Search and Acquisition Services for the fiscal year ending March 31, 2005 are greater than \$5.0 million, the earnout shares will equal 200,000 shares of Company's common stock. If the earnout shares are paid out, an adjustment to the goodwill will be made.

The following unaudited pro forma revenues, net loss, and net loss per share data for the six months ended September 30, 2004 and 2003 are based on the respective historical financial statements of the Company and Marketleap. The pro forma data reflects the consolidated results of operations as if the merger with Marketleap had occurred at the beginning of each of the periods indicated and includes the amortization of the resulting intangible assets and stock-based compensation. The pro forma financial data presented are not necessarily indicative of the Company's results of operations that might have occurred had the transaction been completed at the beginning of the periods specified, and do not purport to represent what the Company's consolidated results of operations might be for any future period.

Six Months Ended September 30,	
2004	2003

	(In thousands, except per share data)	
Revenues	\$ 21,099	\$ 22,364
Net loss	\$ (3,353)	\$ (1,015)
Net loss per common share basic and diluted	\$ (0.10)	\$ (0.03)

Note 4. Stock-Based Compensation

SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 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.

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The Company accounts for its non-employee stock-based-compensation under the fair value based method. The fair value of each option granted is estimated at the date of grant using the Black-Scholes option-pricing model and the remaining unvested options are reevaluated at the end of each reporting period to reflect the fluctuations in the Company's stock price. The non-employee stock-based-compensation expense is recognized on an accelerated basis over the related service period.

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 123, the net income (loss) would have been increased to the pro forma amounts indicated below (in thousands, except per share amounts):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Net income (loss), as reported	\$ (2,015)	\$ 108	\$ (2,899)	\$ (185)
Add: Stock-based employee compensation expense included in reported net loss	432	17	432	42
Deduct: employee stock-based compensation determined under fair value based method for all awards	(974)	(346)	(1,584)	(720)
Pro forma net loss, fair value method for all stock-based awards	<u>\$ (2,557)</u>	<u>\$ (221)</u>	<u>\$ (4,051)</u>	<u>\$ (863)</u>
Basic net income (loss) per share:				
As reported	\$ (0.06)	\$ 0.00	\$ (0.08)	\$ (0.01)
Pro forma	\$ (0.07)	\$ (0.01)	\$ (0.12)	\$ (0.03)
Diluted net income (loss) per share:				
As reported	\$ (0.06)	\$ 0.00	\$ (0.08)	\$ (0.01)
Pro forma	\$ (0.07)	\$ (0.01)	\$ (0.12)	\$ (0.03)

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 weighted average assumptions:

Stock Options			
Three Months Ended September 30,		Six Months Ended September 30,	
2004	2003	2004	2003

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Expected volatility	70%	90%	70%	90%
Weighted average risk-free interest rate	3.51%	2.92%	3.33%	2.78%
Expected life in years	4	4	4	4 to 6.5
Expected dividends	0%	0%	0%	0%

Employee Stock Purchase Plan

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Expected volatility	70%	90%	70%	90%
Weighted average risk-free interest rate	1.78%	1.18%	1.56%	1.28%
Expected life in years	.75	.75	.75	.75
Expected dividends	0%	0%	0%	0%

The weighted average fair value per share of options granted at fair market value for the three and six months ended September 30, 2004 was \$1.40 and \$1.54, respectively, and the weighted average fair value per share of options granted at fair market value for the three and six months ended September 30, 2003 was \$2.53 and \$2.02, respectively.

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The pro forma impact of options on the net loss for the three and six months ended September 30, 2004 and 2003, 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.

Note 5. Net Income (Loss) Per Share Computation

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of vested common shares outstanding for the period. Diluted net income (loss) per share is calculated giving effect to all dilutive potential common shares, including options and preferred stock. A reconciliation of the numerators and denominators used in the basic and diluted net income (loss) per share amounts follows (amounts in thousands, except per share data):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Numerator:				
Numerator for basic and diluted per share amounts net income (loss)	\$ (2,015)	\$ 108	\$ (2,899)	\$ (185)
Denominator:				
Denominator for basic net income (loss) per share weighted average shares	34,650	32,780	34,460	32,240
Effect of dilutive securities: stock options and shares subject to repurchase		2,882		
Denominator for diluted net income (loss) per share	34,650	35,662	34,460	32,240
Basic net income (loss) per share	\$ (0.06)	\$ 0.00	\$ (0.08)	\$ (0.01)
Diluted net income (loss) per share	\$ (0.06)	\$ 0.00	\$ (0.08)	\$ (0.01)

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

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Options	7,861	1,100	7,861	5,800
Shares subject to repurchase				100

Note 6. Restructuring Charges

In the fourth quarter of fiscal 2004, the Company initiated a cost reduction which included the termination of 19 employees and will result in the closure of our Santa Monica office in December 2004. As of September 30, 2004, approximately \$8,000 remained in *Accrued Liabilities* for future severance payments. It is expected to be paid by the end of December 2004.

Note 7. Intangible Assets

Intangible assets consist of the following (in thousands):

	September 30, 2004	September 30, 2003
	<u> </u>	<u> </u>
Purchased intangibles	\$ 2,255	\$ 1,930
Accumulated amortization	(1,969)	(1,930)
	<u> </u>	<u> </u>
	<u>\$ 286</u>	<u>\$</u>

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In the quarter ended September 30, 2004, the Company recorded \$325,000 in intangibles related to the acquisition of Marketleap. These assets will be amortized over three years. Approximately \$117,000, \$156,000, \$49,000 and \$3,000 of the amortization will be recognized for the fiscal years 2005, 2006, 2007 and 2008, respectively. Amortization expense was \$39,000 and \$53,000 for the three months ended September 30, 2004 and 2003, respectively. Amortization expense was \$39,000 and \$214,000 for the six months ended September 30, 2004 and 2003, respectively. The Intangible assets related to the acquisition of MineShare in July 2000 have been fully amortized as of September 30, 2003.

Note 8. 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 stipulation of settlement for the claims against the issuer-defendants, including the Company, has been submitted to the court. The settlement is subject to a number of conditions, including approval of 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. The outcome of this litigation is uncertain and no estimate of liability can be made at this time.

On February 23, 2004, the Company filed a patent infringement lawsuit against Responsys, Inc., a competitor of the Company. The lawsuit, captioned *Digital Impact, Inc. v. Responsys, Inc.*, N. D. Cal., Case No. C04 00734 (SBA), alleges that Responsys has infringed and is continuing to infringe the Company's U.S. Patent No. 6,449,634. The complaint seeks injunctive relief and unspecified damages. Responsys filed an answer and counterclaim on March 15, 2004. The counterclaim seeks a declaration that the patent is invalid or, in the alternative, that Responsys's technology does not infringe the patent. The Company replied to the counterclaim on April 7, 2004, denying all material allegations. Responsys then filed a motion for judgment on the pleadings, which was denied on June 4, 2004.

From time to time, we may be involved in other disputes that arise in the ordinary course of business. Any claims against the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, and result in the diversion of significant operational resources.

During the ordinary course of business, we have included indemnification provisions within our contracts. Pursuant to these agreements, we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally parties with which we have commercial relations, arising from a breach of representations, warranties or covenants and infringement of a third party's intellectual property rights. To date, we have not incurred any costs in connection with such indemnification clauses.

Note 9. Segment Reporting

Digital Impact is organized into two segments: Email Marketing and Agency Services. These segments were determined in fiscal 2003 based on the alignment of the Company's organization structure and selected management financial reporting with the nature of the service product offerings.

Email 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 delivering highly relevant, individualized email messages. Email Marketing represented 69% and 71% of revenue for the three months ended September 30, 2004 and 2003, respectively. The gross margin for Email Marketing was 47% and 60% for the three months ended September 30, 2004 and 2003, respectively.

Agency Services are utilized by clients to enhance marketing programs and improve results. Digital Impact offers clients services in each of the following categories: Strategic Marketing, Search and Acquisition Services, Creative Services, Web Development, Data Management, Measurement and Analytics, Program Delivery and Campaign Automation. Agency Services represented 31% and 29% of revenue for the three months ended September 30, 2004 and 2003, respectively. The gross margin for Agency Services was 39% and 48% for the three months ended September 30, 2004 and 2003, respectively.

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

	Three Months Ended		Six Months Ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Email Marketing revenues	\$ 7,046	\$ 7,771	\$14,624	\$15,305
Agency Services revenues	3,189	3,153	6,022	6,547
Total revenues	10,235	10,924	20,646	21,852
Email Marketing gross profit	3,290	4,629	7,267	8,888
Agency Services gross profit	1,239	1,503	2,538	3,223
Total gross profit	4,529	6,132	9,805	12,111
Operating expenses (not allocated between the segments)	6,560	5,958	12,748	12,176
Other income (expense)	16	(66)	44	(120)
Net income (loss)	\$ (2,015)	\$ 108	\$ (2,899)	\$ (185)

Note 10. Subsequent Event

On October 1, 2004, Digital Impact entered into a Loan and Security Agreement with Silicon Valley Bank that provides for an \$8.0 million revolving line of credit. The revolving loans will bear interest at a floating rate of interest equal to the greater of Silicon Valley Bank's prime rate or 4.0%. On September 30, 2005, the revolving line of credit matures and Silicon Valley Bank's commitment to extend the revolving loans under the Loan and Security Agreement terminates. The revolving and term loans under the Loan and Security Agreement are secured by a first priority lien on substantially all of the assets of Digital Impact, excluding intellectual property. The occurrence of an event of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of Digital Impact's obligations under the Loan and Security Agreement and foreclosure on the collateral securing its obligation under the Loan and Security Agreement. As of September 30, 2004, there have been no borrowings on the loan.

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

The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed below. Additional factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section entitled "Certain Factors Which May Impact Operating Results", included in this Report. When used in this document, the words believes, expects, anticipates, intends, plans and similar expressions, are intended to identify certain of these forward-looking statements. However, these words are not the exclusive means of identifying such statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or

circumstances are forward-looking statements. The cautionary statements made in this document should be read as being applicable to all related forward-looking statements wherever they appear in this document. You should read the following discussion in conjunction with our Consolidated Financial Statements and related notes. Unless required by law, we undertake no obligation to update any forward-looking statements in this Report.

Overview

Digital Impact is a leading provider of integrated digital marketing solutions for Global 2000 enterprises. We draw on our industry specific expertise, our comprehensive methodology for creating programs to address specific marketing objectives and our proprietary technology platform to deliver marketing campaigns through email as well as websites, search and other media. We derive revenues and cash flows primarily from two business segments: Email Marketing and Agency Services.

The Email Marketing segment derives revenue from 1) the IMPACT (IMPACT) email software platform sold as a subscription-based hosted service and 2) account management services such as email campaign targeting, testing, delivery and reporting.

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The Agency Services segment derives revenue from project-based and retainer-based fees for marketing strategy, advanced analytics, data management, creative webpage design, customer acquisition and search engine marketing services.

On July 12, 2004, the Company acquired all of the outstanding equity of Marketleap.com, Inc. We expect that the combination of Digital Impact's strengths in email marketing with Marketleap's experience in search engine marketing will offer clients true integrated digital online marketing. Digital Impact expects to be able to assist clients in managing their customers through the entire lifecycle of awareness, consideration, purchase and loyalty, through a combination of email and search marketing strategy, analytics and campaign execution. Digital Impact expects the acquisition to result in approximately \$1.5 million of additional net revenues for fiscal 2005.

Members of our senior management regularly review key financial information including net revenues by segment, operating expenses and margins, net income, earnings per share, and cash flow. They also review key operating metrics such as service mix, major account trends and email delivery volume. This information allows us to monitor the growth and profitability of our business and evaluate the effectiveness of investments that we have made and continue to make in the areas of client services, product development, marketing and data center operations.

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 revenue recognition, accounting for internal-use software, allowance for doubtful accounts, valuation of long-lived assets and goodwill, and accounting for stock-based compensation. 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;

estimating valuation allowances, specifically the allowance for doubtful accounts;

accounting for internal-use software;

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. Email 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, which are part of Agency Services 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 three general categories: List Rental programs, Co-registration programs, and search engine marketing. 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. Co-registration 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. Search engine marketing involves assisting clients in the use of search engines to acquire customers. Digital Impact contracts with third-party providers to deliver names of individuals who opt-in to join the client's email list or, in the use of search, to deliver specific content in response to user search queries. Digital Impact is obligated to make

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payments to third-parties for the cost of services associated with the execution of List Rental, Co-registration and search engine marketing 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 costs of Customer Acquisition campaigns are estimated using work order commitments when final vendor invoices have not been received. The costs 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: most of the time, the supplier, not the Company, is the primary obligor in the arrangement, 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, 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, and the client approves the supplier selection and the service specifications.

Digital Impact provides other complementary services to clients, which are also part of our Agency Services revenues, such as strategic marketing, campaign automation, web-page development, creative services, measurement and analytics, program delivery and data management. These services are typically billed on an hourly rate or as a fixed project price. The revenue for engagements that support the delivery of future products and services 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 customer's 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.

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 \$8.2 million, net of allowance for doubtful accounts of \$323,000, as of September 30, 2004.

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 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. 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 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 September 30, 2004, we believe that no such impairment of internal-use software existed.

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:

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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 \$9.4 million as of September 30, 2004.

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. On March 31, 2004, the FASB issued a proposed Statement, *Share-Based Payment*, an amendment of FASB Statements Nos. 123 and 95. The proposed statement would eliminate the ability to account for share-based compensation transactions using APB No. 25 and generally would require that such transactions be accounted for using a fair-value-based method and recognized as expenses in our consolidated statement of operations. Should this proposed statement be finalized in its current form, it will have a significant impact on our consolidated statement of operations.

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 September 30,			
	2004		2003	
Net Revenues:				
Email Marketing	\$ 7,046	69%	\$ 7,771	71%
Agency Services	3,189	31%	3,153	29%

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Total net revenues	<u>10,235</u>	<u>100%</u>	<u>10,924</u>	<u>100%</u>
Cost of revenues:				
Email Marketing	3,756	37%	3,142	29%
Agency Services	<u>1,950</u>	<u>19%</u>	<u>1,650</u>	<u>15%</u>
Cost of revenues	<u>5,706</u>	<u>56%</u>	<u>4,792</u>	<u>44%</u>
Gross profit	<u>4,529</u>	<u>44%</u>	<u>6,132</u>	<u>56%</u>
Operating expenses:				
Research and development	845	8%	1,290	12%
Sales and marketing	3,827	37%	2,914	26%
General and administrative	<u>1,888</u>	<u>19%</u>	<u>1,754</u>	<u>16%</u>
Total operating expenses	6,560	64%	5,958	54%
Income (loss) from operations	<u>(2,031)</u>	<u>(20%)</u>	<u>174</u>	<u>2%</u>
Other income and (expense), net	<u>16</u>	<u>0%</u>	<u>(66)</u>	<u>(1%)</u>
Net income (loss)	<u>\$ (2,015)</u>	<u>(20%)</u>	<u>\$ 108</u>	<u>1%</u>

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Three Months Ended September 30, 2004 and 2003

Revenues

Our Email 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 optimal segments and offers, and delivering highly relevant, individualized email messages. Email Marketing represented 69% and 71% of revenue for the three months ended September 30, 2004 and 2003, respectively.

The Agency Services group provides expertise to enhance marketing programs and improve results. Digital Impact offers clients services in each of the following categories: Strategic Marketing, Search and Acquisition Services, Creative Services, Web Development, Data Management, Measurement and Analytics, Program Delivery and Campaign Automation. Agency Services represented 31% and 29% of revenue for the three months ended September 30, 2004 and 2003, respectively.

Total revenues decreased by 6% to \$10.2 million for the three months ended September 30, 2004 from \$10.9 million for the three months ended September 30, 2003. Email Marketing revenues decreased \$725,000 due to client attrition, price erosion and client mix. Agency Services revenues were unchanged as search marketing revenues offset a decline in list rental revenues.

For the full fiscal year 2005, we are projecting revenues to be in the range of \$41 million to \$42 million.

Cost of Revenues

Cost of revenues consists primarily of expenses relating to the delivery of online direct marketing services, including personnel costs of our Email Marketing and Agency Services staff, the amortization of equipment, purchased and licensed technology, data center expenses, software and hardware maintenance costs and stock-based compensation.

Total cost of revenues increased 19% to \$5.7 million for the three months ended September 30, 2004 from \$4.8 million for the three months ended September 30, 2003. The increase in cost of revenues was primarily related to an increase in personnel costs, resulting primarily from higher staffing in Agency Services. The increase was also related to a \$108,000 increase in stock-based compensation related to the acquisition of Marketleap and higher outside services and contractors expenses.

Gross margin decreased to 44% for the three months ended September 30, 2004 from 56% for the three months ended September 30, 2003. The decline in gross margin was due to a 19% increase in cost of revenues while revenue decreased by 6%. Gross margin for Email Marketing was 47% and 60% for the three months ended September 30, 2004 and 2003, respectively. The decrease in gross margin for Email Marketing is primarily the result of the lower revenues and a higher cost of revenues. The increase in cost of revenues was primarily related to an increase in personnel costs, resulting primarily from higher staffing. Gross margin for Agency Services was 39% and 48% for the three months ended September 30, 2004 and 2003, respectively. This decline is primarily due to the replacement of high margin list rental business with lower gross margin agency services.

We expect that gross margins for fiscal year 2005 will be about 45%, as we maintain our investment in agency services to support potential growth in fiscal 2006.

Operating Expenses

Our operating expenses are classified into three general categories: research and development, sales and marketing, and general and administrative. We classify all charges to these operating expense categories based on the nature of the expenditures. Although each category includes expenses that are unique to each operating category, some expenditures,

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such as compensation, employee benefits, recruiting costs, travel and entertainment costs, facilities costs, third-party professional service fees and non-cash stock-based compensation, occur in each of these categories.

Stock-based compensation was \$524,000 and \$17,000 for the three months ended September 30, 2004 and 2003, respectively. The increase in stock-based compensation was due to grants associated with the acquisition of Marketleap. For the quarters ended September 30, 2004 and 2003, stock-based compensation was included in cost of revenues, general and administrative, research and development, and sales and marketing expenses.

Amortization of purchased intangibles was \$39,000 for the three months ended September 30, 2004, attributed to the \$325,000 of intangibles acquired through the acquisition of Marketleap. For the three months ended September 30, 2004, \$11,000 and \$28,000 of the amortization was included in cost of goods sold and sales and marketing expenses, respectively. Amortization of purchased intangibles was \$53,000 for the three months ended September 30, 2003, related to the purchased technology from our July 2000 acquisition of MineShare. As of September 30, 2003, the MineShare purchased intangibles have been fully amortized.

We allocate the facilities costs to each functional area based on each area's relative headcount. These allocated charges include rent and other facility-related costs, communication charges and depreciation expense for furniture and equipment.

Research and Development. Research and development expenses consist primarily of personnel and related costs, consultants and outside contractor costs. Research and development expenses declined by 34% to \$0.8 million for the quarter ended September 30, 2004 from \$1.3 million for the quarter ended September 30, 2003. The decline is primarily a result of a \$379,000 reduction in personnel costs, resulting from lower headcount driven by the closure of Santa Monica research and development facility. We capitalized \$21,000 and \$53,000 for internally developed software for the three months ended September 30, 2004 and 2003, respectively. For the three months ended September 30, 2004, the Company amortized approximately \$26,000 of the capitalized software development costs. The company did not amortize any of the software development costs for the three months ended September 30, 2003.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs for our direct sales force and marketing staff, and marketing programs, which include trade shows, advertisements, promotional activities and media events. Sales and marketing expenses increased by 31% to \$3.8 million for the three months ended September 30, 2004 from \$2.9 million for the three months ended September 30, 2003. The increase was mainly attributable to an increase in personnel costs due to higher staffing and personnel costs in account management and a \$322,000 increase in stock-based compensation related to the acquisition of Marketleap. During the fiscal year ending March 31, 2005, we expect sales and marketing expenses to increase about 20% over the prior year as a result of higher personnel costs and staffing, non-cash stock-based compensation due to the acquisition of Marketleap, and allocated overhead.

General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate purposes, including information technology, finance, accounting, human resources, facilities and legal. General and administrative expenses increased by 8% to \$1.9 million for the three months ended September 30, 2004, from \$1.8 million for the three months ended September 30, 2003. The increase was primarily due to a \$35,000 increase in accounting and legal fees, a \$72,000 increase in contractor expenses, and a \$69,000 increase in stock-based compensation primarily related to the acquisition of Marketleap. During the fiscal year ending March 31, 2005, we expect general and administrative expenses to increase modestly in absolute dollars over the prior fiscal year.

Other Income and (expense). Other income and (expense) was \$16,000 for the three months ended September 30, 2004, compared to (\$66,000) for the three months ended September 30, 2003. Other income relates to interest income on cash, cash equivalents and short-term investments. Other expenses relate primarily to interest paid on leases and

debt, and losses on disposals of fixed assets. Other expenses decreased as a result of a decline in interest paid on long-term debt and the expiration of equipment leases.

Income taxes. No provision for federal and state income taxes was recorded as we incurred net operating losses from inception through September 30, 2004. 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 may further restrict our ability to utilize our net operating loss carryforwards.

Table of Contents**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.

	Six Months Ended September 30,			
	2004		2003	
Net Revenues:				
Email Marketing	\$ 14,624	71%	\$ 15,305	70%
Agency Services	6,022	29%	6,547	30%
	<hr/>	<hr/>	<hr/>	<hr/>
Total net revenues	20,646	100%	21,852	100%
	<hr/>	<hr/>	<hr/>	<hr/>
Cost of revenues:				
Email Marketing	7,357	35%	6,417	29%
Agency Services	3,484	17%	3,324	15%
	<hr/>	<hr/>	<hr/>	<hr/>
Cost of revenues	10,841	52%	9,741	44%
	<hr/>	<hr/>	<hr/>	<hr/>
Gross profit	9,805	48%	12,111	56%
	<hr/>	<hr/>	<hr/>	<hr/>
Operating expenses:				
Research and development	1,829	9%	2,744	13%
Sales and marketing	7,211	35%	5,965	27%
General and administrative	3,708	18%	3,467	16%
	<hr/>	<hr/>	<hr/>	<hr/>
Total operating expenses	12,748	62%	12,176	56%
Loss from operations	(2,943)	(14%)	(65)	(0%)
	<hr/>	<hr/>	<hr/>	<hr/>
Other income and (expense), net	44	0%	(120)	(1%)
	<hr/>	<hr/>	<hr/>	<hr/>
Net loss	\$ (2,899)	(14%)	\$ (185)	(1%)
	<hr/>	<hr/>	<hr/>	<hr/>

Six Months Ended September 30, 2004 and 2003

Revenues

Email Marketing revenues decreased by 4% to \$14.6 million for the six months ended September 30, 2004 from \$15.3 million for the six months ended September 30, 2003. Email Marketing represented 71% and 70% of total revenues for the six months ended September 30, 2004 and 2003, respectively.

Agency Services revenues were \$6.0 million and \$6.5 million for the six months ended September 30, 2004 and 2003, respectively. Agency Services represented 29% and 30% of total revenues for the six months ended September 30, 2004 and 2003, respectively.

Total revenues decreased by 6% to \$20.6 million for the six months ended September 30, 2004 from \$21.9 million for the six months ended September 30, 2003. Email Marketing revenues declined \$681,000 due to price erosion, client attrition and client mix. Agency Services revenues declined \$525,000 due to the decline in our list rental business partially offset by an increase in search marketing.

Cost of Revenues

Total cost of revenues increased by 11% to \$10.8 million for the six months ended September 30, 2004 from \$9.7 million for the six months ended September 30, 2003. The increase in cost of revenues was primarily related to an increase in personnel costs, resulting primarily from higher headcount in Agency Services. The increase was also related to \$108,000 increase in stock-based compensation related to the acquisition of Marketleap and higher outside services and contractors expenses.

Gross margin decreased to 48% for the six months ended September 30, 2004 from 56% for the six months ended September 30, 2003. The decline in gross margin was due to an 11% increase in cost of revenues while revenue decreased by 6%. Gross margin for Email Marketing was 50% and 58% for the six months ended September 30, 2004 and 2003, respectively. The decrease in gross margin for Email Marketing is primarily the result of the lower revenues

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and a higher cost of revenues. The increase in cost of revenues was primarily related to an increase in personnel costs, resulting primarily from higher staffing. Gross margin for Agency Services was 42% and 49% for the six months ended September 30, 2004 and 2003, respectively. This decline is primarily due to the replacement of high margin list rental business with lower gross margin agency services.

Operating Expenses.

Stock-based compensation was \$552,000 and \$42,000 for the six months ended September 30, 2004 and 2003, respectively. The increase in stock-based compensation was due to grants associated with the acquisition of Marketleap. For the six months ended September 30, 2004 and 2003, stock-based compensation was included in cost of revenues, general and administrative, research and development, and sales and marketing expenses.

Amortization of purchased intangibles was \$39,000 for the six months ended September 30, 2004, attributed to the \$325,000 of intangibles acquired through the acquisition of Marketleap. For the six months ended September 30, 2004, \$11,000 and \$28,000 of the amortization was included in cost of goods sold and sales and marketing expenses, respectively. Amortization of purchased intangibles was \$214,000 for the six months ended September 30, 2003, related to the purchased technology from our July 2000 acquisition of MineShare. As of September 30, 2003, the MineShare purchased intangibles have been fully amortized.

Research and Development. Research and development expenses consist primarily of personnel and related costs, consultants and outside contractor costs. Research and development expenses declined by 33% to \$1.8 million for the six months ended September 30, 2004 from \$2.7 million for the six months ended September 30, 2003. The decline is primarily a result of a \$713,000 reduction in personnel costs, resulting from lower headcount and a \$108,000 decrease in relocation expenses. We capitalized \$38,000 and \$176,000 for internally developed software for the six months ended September 30, 2004 and 2003, respectively. For the six months ended September 30, 2004 and 2003, the Company amortized approximately \$26,000 and \$27,000 of software development costs, respectively.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs for our direct sales and marketing staff, and marketing programs, which include trade shows, advertisements, promotional activities and media events. Sales and marketing expenses increased by 21% to \$7.2 million for the six months ended September 30, 2004 from \$6.0 million for the six months ended September 30, 2003. The increase was mainly attributable to an increase in personnel costs due to higher staffing in account management and a \$322,000 increase in stock-based compensation related to the acquisition of Marketleap. During the fiscal year ending March 31, 2005, we expect sales and marketing expenses to increase about 20% over the prior year as a result of higher personnel costs and staffing, non-cash stock-based compensation due to the acquisition of Marketleap, and allocated overhead.

General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate purposes, including information technology, finance, accounting, human resources, facilities and legal. General and administrative expenses increased by 7% to \$3.7 million for the six months ended September 30, 2004, from \$3.5 million for the six months ended September 30, 2003. The increase was primarily due a \$106,000 increase in accounting and legal fees, a \$116,000 increase in contractor expenses, and a \$69,000 increase in stock-based compensation primarily related to the acquisition of Marketleap. During the fiscal year ending March 31, 2005, we expect general and administrative expenses to increase modestly in absolute dollars over the prior fiscal year.

Other Income and (expense). Other income and (expense) was \$44,000 for the six months ended September 30, 2004, compared to (\$120,000) for the six months ended September 30, 2003. Other income relates to interest income on cash, cash equivalents and short-term investments. Other expenses relate primarily to interest paid on leases and debt, and losses on disposals of fixed assets. Other expenses decreased as a result of a decline in interest paid on

long-term debt and the expiration of equipment leases.

Income taxes. No provision for federal and state income taxes was recorded as we incurred net operating losses from inception through September 30, 2004. 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 may further restrict our ability to utilize our net operating loss carryforwards.

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Liquidity and Capital Resources

Cash and Investments.

As of September 30, 2004, we had \$23.9 million in cash, cash equivalents and short-term investments and working capital of \$26.9 million. In addition, as of September 30, 2004, we had \$1.2 million in restricted cash, \$1.1 million of which is supporting letters of credit issued against certain contractual lease obligations.

Cash Flow from Operating Activities.

Our operating activities generated \$102,000 and \$81,000 of cash for the six months ended September 30, 2004 and 2003, respectively. Net cash generated by operating activities for the six months ended September 30, 2004 consisted of the net loss of \$2.9 million, offsetting non-cash items of \$2.8 million, and an increase in cash of \$163,000 arising from changes in assets and liabilities. For the six months ended September 30, 2004, the deferred revenues decreased by \$704,000 due to a decrease in campaign automation and web development activities relative to the current period earnings for activities deferred over the prior twelve months. The accrued pass-through vendor costs increased by \$570,000, for the six months ended September 30, 2004, due to the increase in vendor liabilities for the work completed in the quarter. Cash provided by operating activities for the six months ended September 30, 2003 resulted from the net loss of \$185,000, offsetting non-cash items of \$2.9 million, and a decrease in cash of \$2.6 million arising from changes in operating assets and liabilities.

Cash Flow from Investing Activities.

Our investing activities used net cash of \$1.9 million for the six months ended September 30, 2004 compared to \$2.5 million used by investing activities for the six months ended September 30, 2003. Net cash used in investing activities for the six months ended September 30, 2004 primarily related to acquisition of Marketleap totaling \$1.7 million and acquisitions of property and equipment totaling \$871,000, partially offset by maturities of marketable securities of \$500,000. Net cash used in investing activities for the six months ended September 30, 2003 was attributable to acquisitions of property and equipment totaling \$1.1 million and purchases of short-term investments totaling \$1.5 million.

Cash Flow from Financing Activities.

For the six months ended September 30, 2004, our financing activities provided net cash of \$74,000 compared to net cash of \$1.3 million provided by financing activities for the six months ended September 30, 2003. Net cash provided by financing activities for the six months ended September 30, 2004 consisted of proceeds from option exercises and employee stock plan purchases totaling \$558,000, partially offset by principal payments on long-term debt of \$295,000 and purchase of treasury stock of \$189,000. Net cash provided by financing activities for the six months ended September 30, 2003 was attributable to the proceeds from option exercises and employee stock plan purchase totaling \$2.2 million, partially offset by principal payments on long-term debt totaling \$896,000 and purchases of treasury stock totaling \$39,000.

Debt Payments.

At September 30, 2004 we had borrowings in the form of long-term debt, payable in quarterly installments through April 2006. Total debt as of September 30, 2004 was \$424,000, with \$265,000 bearing an interest rate of 3% and \$159,000 bearing an interest rate of 2%.

Commitments.

We are committed to making cash payments in the future on our purchase obligations, notes payable 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. Our credit agreements place restrictions on our ability to pay dividends.

Future Cash Needs.

Digital Impact has made certain commercial commitments that extend beyond our fiscal year ending March 31, 2005. 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.

priority lien on substantially all of the assets of Digital Impact, excluding intellectual property. The occurrence of an event of default will increase the applicable rate of interest by 2.0% and could result in the acceleration of Digital Impact's obligations under the Loan and Security Agreement and foreclosure on the collateral securing its obligation under the Loan and Security Agreement. As of September 30, 2004, there have been no borrowings on the loan.

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.

Indemnification Provisions.

During the ordinary course of business, we have included indemnification provisions within our contracts. Pursuant to these agreements, we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally parties with which we have commercial relations, arising from a breach of representations, warranties or covenants and infringement of a 3rd party's intellectual property rights. To date, we have not incurred any costs in connection with such indemnification clauses.

Recent Accounting Pronouncements

In April 2004, the Emerging Issues Task Force issued Statement No. 03-06 Participating Securities and the Two-Class Method Under FASB Statement No. 128, Earnings Per Share (EITF 03-06). EITF 03-06 addresses a number of questions regarding the computation of earnings per share by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company when, and if, it declares dividends on its common stock. EITF 03-06 also provides further guidance in applying the two-class method of calculating earnings per share, clarifying what constitutes a participating security and how to apply the two-class method of computing earnings per share once it is determined that a security is participating, including how to allocate undistributed earnings to such a security. EITF 03-06 is effective for fiscal periods beginning after March 31, 2004. The Company has evaluated the effect of adopting EITF 03-06 and does not believe that it will have any effect on its results of operations or net income per share.

On March 31, 2004, the FASB issued a proposed Statement, Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95, that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or, liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity

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instruments. The proposed statement would eliminate the ability to account for share-based compensation transactions using Accounting Principles Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees, and generally would require that such transactions be accounted for using a fair-value-based method and recognized as expenses in our consolidated statement of income. The proposed standard would require the modified prospective method be used, which would require that the fair value of new awards granted from the beginning of the year of adoption plus unvested awards at the date of adoption be expensed over the vesting period. In addition, the proposed statement encourages companies with adequate exercise history to use the binomial approach to value stock options, which differs from the Black-Scholes option pricing model that we currently use to determine the fair value of our options. The proposed standard is recommending that the effective date for public companies be fiscal periods beginning after June 15, 2005. Should this proposed statement be finalized in its current form, it will have a significant impact on our consolidated statement of operations as we will be required to expense the fair value of our stock options rather than disclosing the impact on our consolidated net loss within our notes as is our current practice.

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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 experienced lower prices in recent quarters. 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, especially among retail clients, as a result of the holiday season. 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. The mix of our clients between retail and other businesses may also affect the severity of the fluctuation during the calendar year-end months. Due to 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.

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

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

The loss of a major client could harm our business. While two clients each accounted for more than 10% of our revenues and our top 30 clients represented approximately 82% of our revenues for the six months ended September 30, 2004, the loss of one or more of these clients 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, Experian, Silverpop, Bigfoot Interactive, InfoUSA and ExactTarget as well as the in-house information technology departments of our existing and prospective clients and interactive agencies such as Dipitas and aQuantive. 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 and the migration of customers to this new technology entail 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. Also, if we are not successful in a smooth migration of our customers to our new or enhanced technology and services, we could 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.

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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 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,

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exposing us to liability. In addition, our reputation may be harmed if we lose customer information maintained in our data warehouse due to systems interruptions or other reasons.

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

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

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

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

In December 2003, Congress 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.

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.

If our independent auditor is unable to provide us with an unqualified report as to the adequacy of our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002, investors could lose confidence in the reliability of our financial statements, which could result in a decrease in the value of our common stock.

Under the Sarbanes-Oxley Act of 2002, we are required to assess the effectiveness of our internal controls for financial reporting and assert that such internal controls are effective. For our fiscal year ended March 31, 2006, an independent registered public accounting firm must also conduct an audit to evaluate management's assessment concerning the effectiveness of the internal controls over financial reporting and render an opinion on our assessment and the effectiveness of internal controls over financial reporting. To prepare for compliance with the Sarbanes-Oxley Act of 2002 we have undertaken certain actions including the adoption of an internal plan which includes a timeline and schedule of activities for the evaluation, test, and remediation, if necessary, of internal controls. Although we believe that our efforts will enable us to provide the required report and the independent registered public accounting firm to provide the required attestation as of our fiscal year ended March 31, 2006, we can give no assurance that such efforts will be completed in a timely manner and on a successful basis. If this were to occur, we may be unable to assert that the internal controls over financial reporting are effective, or the independent registered public accounting firm may not be able to render the required attestation concerning our assessment and the effectiveness of the internal controls over financial reporting. This may impact the reliability of our internal controls over financial reporting, which may adversely affect the market price of our common stock.

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We may not realize expected benefits from our recent acquisition.

We expect our recent acquisition of Marketleap to, among other things, result in additional net revenues for fiscal year 2005 and enhance our robust integrated marketing solutions. Achieving the benefits of our recent acquisition of Marketleap will depend in part on our integration of its technology, operations and personnel, and our demonstration to customers that the acquisition will not result in adverse changes in client service standards. In this regard, we may be required to spend additional time or money on integration, which would otherwise be spent on developing our own business and services. It is not certain that we can successfully complete the required integration in a timely manner, or at all, or that any of the anticipated benefits of the acquisition will be realized. If we do not integrate the technology and operations effectively or if management spends too much time on integration issues, it could harm our business, financial condition and operating results.

With respect to the integration of personnel, despite our efforts to retain the key employees of Marketleap, we may not be successful, as competition for qualified management and technical employees in our industry is intense, and we may have a different corporate culture and these key employees may not want to work for a larger, publicly-traded company. In addition, competitors may recruit these key employees during the integration process, as is common in technology acquisitions. As a result, these key employees could leave with little or no prior notice, which could impede the integration process and harm our business, financial condition and operating results. In this regard, in connection with the acquisition certain key employees have entered into employment and non-competition agreements which will restrict their ability to compete with us if they leave. We cannot assure you of the enforceability of these non-competition agreements or that these employees will continue to work with us under their employment agreements.

If we acquire additional companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value or adversely affect our operating results.

In addition to the acquisition that we have recently completed, we may acquire or make investments in other complementary companies, services and technologies in the future. If we fail to properly evaluate and execute acquisitions and investments, they may seriously harm our business and prospects. To successfully complete an acquisition, we must:

properly evaluate the business, personnel and technology of the company to be acquired;

accurately forecast the financial impact of the transaction, including accounting charges and transaction expenses;

integrate and retain personnel;

combine potentially different corporate cultures;

effectively integrate products and research and development, sales, marketing and support operations; and

maintain focus on our day-to-day operations.

Further, the financial consequences of our acquisitions and investments may include potentially dilutive issuances of equity securities, one-time write-offs, amortization expenses related to goodwill and other intangible assets and the incidence of contingent liabilities.

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 use derivative financial instruments in our investment portfolio. We ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in high quality securities.

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Foreign Currency Risk

For the period from our inception through September 30, 2004, 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 three and six months ended September 30, 2004 and 2003, respectively.

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 September 30, 2004, we had \$93,000 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.

Like other public companies, we are preparing for new accounting disclosures required by rules and regulations adopted in connection with the Sarbanes-Oxley Act of 2002. In particular, we are preparing to provide, beginning with our annual report on Form 10-K for the fiscal year ending March 31, 2006, management's report on our internal control over financial reporting and auditors' attestation with respect to our report required by Section 404 of the Sarbanes-Oxley Act. In recent months, we updated our documentation and will continue to update the documentation of our system of internal controls which is the necessary foundation for the evaluation and Section 404 certification by management. Non-material changes have been made in certain controls and further changes are possible as a result of these efforts.

There were no changes 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 stipulation of settlement for the claims against the issuer-defendants, including the Company, has been submitted to the court. The settlement is subject to a number of conditions, including approval of 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. The outcome of this litigation is uncertain and no estimate of liability can be made at this time.

On February 23, 2004, the Company filed a patent infringement lawsuit against Responsys, Inc., a competitor of the Company. The lawsuit, captioned *Digital Impact, Inc. v. Responsys, Inc.*, N. D. Cal., Case No. C04 00734 (SBA), alleges that Responsys has infringed and is continuing to infringe the Company's U.S. Patent No. 6,449,634. The

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complaint seeks injunctive relief and unspecified damages. Responsys filed an answer and counterclaim on March 15, 2004. The counterclaim seeks a declaration that the patent is invalid or, in the alternative, that Responsys's technology does not infringe the patent. The Company replied to the counterclaim on April 7, 2004, denying all material allegations. Responsys then filed a motion for judgment on the pleadings, which was denied on June 4, 2004.

Item 2. Unregistered Sales of Securities and Use of Proceeds

On July 12, 2004, the Company acquired all the outstanding equity of Marketleap.com, Inc. In connection with the acquisition, the Company issued 840,000 shares of its common stock to the stockholders of Marketleap. The shares were issued pursuant to exemptions by reason of Section 4(2) of the Securities Act of 1933 and/or Regulation D promulgated under such Act. The sales were made in private transactions without general solicitation or advertising. Also, in connection with the acquisition, the Company assumed options to purchase approximately 412,000 shares of the Company's common stock. The Company filed a registration statement on Form S-8 with respect to the shares of the Company's common stock issuable upon the exercise of all such options.

On August 2, 2004, an executive of the Company received shares of our common stock in settlement of restricted stock units granted by the Company to such executive in 2001. In connection with this settlement, which resulted in the recognition of income by the executive, the Company withheld 134,062 shares of common stock to satisfy state and federal tax withholding requirements. The closing price of the Company's common stock on the settlement date was \$1.41. This tax withholding event was part of an executive compensation program sponsored by the Company, and was not part of a publicly announced repurchase plan or program. There were no other Company repurchases during the quarter ended September 30, 2004.

Item 3. Defaults Upon Senior Securities

Not applicable.

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

At the Company's Annual Meeting of Stockholders (Annual Meeting) held on July 29, 2004, the following individual was re-elected to the Board of Directors as a Class II director for a term of three years:

	Votes For	Votes Withheld
Edward J. Spiegel	31,644,854	283,740

William Park, Michael Brown, Gerardo Capiel and Peter Pervere continue as either Class I or Class III directors of the Company.

Additionally, at the Company's Annual Meeting, the following proposal was adopted by the margin indicated:

To ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending March 31, 2005. The votes cast for and against this action were 31,874,506 and 46,432, respectively, with 7,656 abstaining.

Item 5. Other Information

Not applicable.

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a) Exhibits

Exhibit No.	Description
2.1(2)	Agreement and Plan of Merger and Reorganization by and among Digital Impact, Inc., Marketleap.com, Inc., Jumper Acquisition Corporation, Noel McMichael, Paul Owen and Noel McMichael as Shareholder Representative, dated July 10, 2004.
10.1(3)	The Registrant's 1998 Stock Plan, as amended and restated
10.2(1)	The Registrant's 1999 Employee Stock Purchase Plan
10.3(8)	The Registrant's 1999 Director Equity Plan, as amended and restated
10.4(1)	Employment Agreement between the Registrant and David Oppenheimer
10.5(5)	Employment Agreement between the Registrant and Kevin Johnson
10.6(6)	Standard Form Lease between the Registrant and Casiopea Venture Corporation
10.7(1)	Form of Indemnification Agreement between the Registrant and each of its directors and executive officers
10.8(4)	Form of Retention Agreement with Key Employees
10.9(6)	Retention Agreement between the Registrant and William Park dated January 11, 2002
10.10(6)	Promissory Note of William Park dated February 7, 2002
10.11(7)	Amendment to Retention Agreement between the Registrant and William Park dated December 23, 2002
10.12(9)	Master Service Agreement between the Registrant and Globix Corporation dated September 25, 2002
10.13(10)	Amendment to the Master Services Agreement between the Registrant and Globix Corporation dated September 30, 2004.
10.14(11)	Loan and Security Agreement, dated October 1, 2004, by and between Silicon Valley Bank and the Registrant.
10.15	Form of 1998 Stock Plan Stock Option Agreement.
10.16	Form of 1999 Director Equity Plan Stock Option Agreement.
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Certification of Chief Executive Officer, as required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.

- 31.2 Certification of Chief Financial Officer, as required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated by reference to Digital Impact's registration statement on Form S-1 (SEC File No. 333-87299) originally filed with the Commission on September 17, 1999, as subsequently amended.
- (2) Incorporated by reference to Digital Impact's Current Report on Form 8-K filed with the Commission on July 12, 2004.
- (3) Incorporated by reference to Digital Impact's Registration Statement on Form S-8 (SEC File No. 333-67686) filed with the Securities and Exchange Commission on August 16, 2001.
- (4) Incorporated by reference to Digital Impact's Report on Form 10-K filed with the Commission on June 13, 2001.
- (5) Incorporated by reference to Digital Impact's Report on Form 10-Q filed with the Commission on February 14, 2002.
- (6) Incorporated by reference to Digital Impact's Report on Form 10-K filed with the Commission on June 7, 2002.
- (7) Incorporated by reference to Digital Impact's Report on Form 10-Q filed with the Commission on February 14, 2003.
- (8) Incorporated by reference to Digital Impact's Proxy Statement on Schedule 14A filed with the Commission on June 24, 2003.
- (9) Incorporated by reference to Digital Impact's Report on Form 10-K filed with the Commission on June 14, 2004.
- (10) Incorporated by reference to Digital Impact's Report on Form 8-K filed with the Commission on October 6, 2004.
- (11) Incorporated by reference to Digital Impact's Report on Form 8-K filed with the Commission on October 6, 2004.

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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: November 11, 2004

DIGITAL IMPACT, INC.
(Registrant)

/s/ WILLIAM PARK
William Park
President, Chief Executive Officer and
Director (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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