DIGITAL IMPACT INC /DE/
Form 10-Q
February 14, 2002

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

FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2001

OR

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

FOR THE TRANSITION PERIOD FROM __________ TO __________

COMMISSION FILE NUMBER: 000-27787

DIGITAL IMPACT, INC.
(Exact name of registrant as specified in its charter)

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

177 BOVET ROAD
SAN MATEO, CALIFORNIA 94402
(Address of principal executive offices)

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

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

Yes [X] No [ ]

As of February 9, 2002, there were approximately 29,122,000 shares of the Registrant's Common Stock outstanding.

DIGITAL IMPACT, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

(Unaudited)

	Three months ended December 31,		Nine months ended December 31,	
	2001	2000	2001	2000
Revenues	$ 10,329	$ 12,156	$ 28,755	$ 30,001
Cost of revenues	4,840	5,326	13,612	13,193
Gross margin	5,489	6,830	15,143	16,808
Operating expenses:				
Research and development	2,493	4,934	9,216	12,800
Sales and marketing	3,576	4,935	12,480	13,085
General and administrative	1,948	3,111	6,566	8,178
Stock-based compensation	278	595	2,428	4,353
Amortization of goodwill and purchased intangibles	375	2,411	1,125	4,018
Write-off of acquired in-process research and development and fixed assets	--	--	--	4,563
Total operating expenses	8,670	15,986	31,815	46,997
Loss from operations	(3,181)	(9,156)	(16,672)	(30,189)
Other income and (expense)	(26)	664	299	2,500
Net loss	$ (3,207)	$ (8,492)	$(16,373)	$(27,689)
Net loss per common share -- basic and diluted	$ (0.11)	$ (0.34)	$ (0.59)	$ (1.17)
Shares used in net loss per common share calculation -- basic and diluted	28,340	25,080	27,650	23,760

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

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

	December 31, 2001	March 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 26,319	$ 35,038
Accounts receivable, net	9,096	12,899
Prepaid expenses and other current assets	1,313	551
Total current assets	36,728	48,488
Property and equipment, net	11,127	13,100
Restricted cash	1,932	1,847
Intangible assets	3,396	5,005
Other assets	494	579
Total assets	$ 53,677	$ 69,019
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,706	$ 4,557
Deferred revenues	1,670	1,050
Accrued payroll	1,599	2,342
Accrued liabilities	915	1,087
Current portion of capital lease obligations	699	862
Current portion of long term debt	1,808	913
Total current liabilities	10,397	10,811
Capital lease obligations, less current portion	123	524
Long term debt, less current portion	1,326	2,129
Total liabilities	11,846	13,464

Stockholders' equity:		
Common Stock	28	28
Additional paid-in capital	142,177	141,822
Accumulated other comprehensive loss	(34)	(34)
Unearned stock-based compensation	(1,843)	(4,387)
Accumulated deficit	(98,100)	(81,727)

Less treasury stock at cost	$ (397)	(147)
Total stockholders' equity	41,831	55,555
Total liabilities and stockholders' equity	$ 53,677	$ 69,019

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

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

	Nine months ended December 31,	
	2001	2000
Cash flows from operating activities		
Net loss	$(16,373)	$(27,689)
Adjustments to reconcile net loss to net cash used in operating activities:		
Write-off of acquired in-process research and development and fixed assets	--	4,563
Depreciation and amortization	6,119	7,262
Provision for (recovery of) bad debts	(67)	1,100
Amortization of unearned stock-based compensation	2,428	4,353
Unrealized loss on cash and cash equivalents	--	(19)
Changes in operating assets and liabilities:		

Accounts receivable	3,870	(10,508)
Prepaid expenses and other current assets	(762)	(231)
Other assets	85	(130)
Accounts payable	(851)	2,132
Accrued liabilities and deferred revenue	(295)	2,116
Net cash used in operating activities	(5,846)	(17,051)
Cash flows from investing activities		
Acquisition of property and equipment	(1,444)	(8,469)
Cash acquired from acquisition	--	264
Restricted cash	(85)	(1,739)
Net cash used in investing activities	(1,529)	(9,944)
Cash flows from financing activities		
Principal payments on long-term debt	(1,565)	(505)
Proceeds from exercise of common stock options and warrants, net of treasury stock repurchases	221	1,438
Net cash (used in) provided by financing activities	(1,344)	933
Net decrease in cash and cash equivalents	(8,719)	(26,062)
Cash and cash equivalents at beginning of period	35,038	68,073
Cash and cash equivalents at end of period	$ 26,319	$ 42,011
Supplemental noncash information:		
Fair value of net assets acquired (excluding transaction costs)	$ --	$ 31,145
Assets acquired under capital leases	$ 1,093	$ 140
Unearned stock-based compensation	$ (148)	$ (1,706)

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

DIGITAL IMPACT, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. THE COMPANY

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

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation and liquidity

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

The accompanying interim condensed consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in Digital Impact's Annual Report on Form 10-K for the fiscal year ended March 31, 2001.

The Company has incurred recurring losses from operations and has an accumulated deficit of approximately $98.1 million as of December 31, 2001. The Company has incurred substantial losses and negative cash flows from operations since inception. For the nine months ended December 31, 2001, the Company incurred a loss from operations of approximately $16.7 million and negative cash flows from operations of approximately $5.8 million.

The Company believes it has sufficient cash and cash equivalents to fund operations for at least the next twelve months.

Principles of Consolidation

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

Comprehensive income

Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner

sources. Other comprehensive loss, a component of stockholders' equity, recorded by the Company for the nine months ended December 31, 2001 was attributable to an unrealized loss on cash equivalents. The Company did not have any additional transactions that were required to be reported in other comprehensive income during the nine months ended December 31, 2001.

Concentration of credit risk and other risks and uncertainties

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

The Company's customers are primarily concentrated in the United States. The Company performs ongoing credit evaluations and establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of customers, historical trends and other information.

NOTE 3. RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 133, or SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 133 establishes new standards of accounting and reporting for derivative instruments and hedging activities. SFAS 133 requires that all derivatives be recognized at fair value in the statement of financial position, and that the corresponding gains or losses be reported either in the statement of operations or as a component of comprehensive income, depending on the type of hedging relationship that exists. SFAS 133 is effective for fiscal years beginning after June 15, 2000. The Company does not currently hold derivative instruments or engage in hedging activities and hence the implementation of SFAS 133 did not have a material impact upon the financial statements of the Company.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 141 "Business Combinations," which established financial accounting and reporting for business combinations and superseded APB Opinion No. 16, Business Combinations, and FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises. It requires that all business combinations in the scope of this Statement are to be accounted for using one method, the purchase method. The provisions of this Statement apply to all business combinations initiated after June 30, 2001.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 142 "Goodwill and Other Intangible Assets," which established financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, Intangible Assets. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition and after they have been initially recognized in the financial statements. The provisions of this Statement are effective starting with fiscal years beginning after December 15, 2001. Early adoption is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued. Accordingly, the Company has elected not to early adopt SFAS No. 142 beginning with the first quarter of fiscal 2002. Upon adoption of FAS 142, the Company will reclassify the amount relating to assembled workforce (currently $1.4 million) from intangible assets to goodwill and will no longer amortize goodwill.

On October 3, 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supercedes SFAS No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends APB Opinion No. 30, "Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell.

Additionally SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for the Company for all financial statements issued in 2002. The adoption of SFAS No. 144 is not expected to have a material impact on the Company's financial statements.

NOTE 4. NET LOSS PER SHARE

Basic net loss per share is computed using the weighted-average number of outstanding shares of common stock, excluding common stock subject to repurchase. Diluted net loss per share is computed using the weighted-average number of outstanding shares of common stock and, when dilutive, potential common shares from options and warrants to purchase common stock and common stock subject to repurchase using the treasury stock method. The following table presents the calculation of basic and diluted net loss per share (in thousands, except per share amounts):

	Three months ended December 31,		Nine months ended December 31,	
	2001	2000	2001	2000
Numerator:				
Net loss	$ (3,207)	$ (8,492)	$(16,373)	$(27,689)
Denominator:				
Weighted average common shares outstanding	28,430	26,790	28,100	25,810
Weighted average unvested common shares subject to repurchase	(90)	(1,710)	(450)	(2,050)
Denominator for basic and diluted calculation	28,340	25,080	27,650	23,760
Net loss per common share -- basic and diluted	$ (0.11)	$ (0.34)	$ (0.59)	$ (1.17)

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

December 31,

	2001	2000
Options	9,005	8,028
Shares subject to repurchase	838	1,715
Warrants	--	3

NOTE 5. STOCK-BASED COMPENSATION

During the nine months ended December 31, 2001, the Company reduced unearned stock-based compensation, a component of stockholders' equity, by approximately $2.6 million. This reduction was the result of amortization of stock-based compensation of approximately $2.4 million and a reduction of approximately $1.8 million related primarily to stock option forfeitures and the revaluation of options granted to consultants, offset by the recording of approximately $1.6 million of deferred compensation related to the issuance of restricted stock in exchange for the

cancellation of options. Unearned stock-based compensation is amortized to expense over the period during which the options and restricted stock vest, generally three to four years, in accordance with FASB Interpretation No. 28.

In May 2001, the Company issued approximately 797,500 shares of restricted stock with a fair value of $1.17 per share in exchange for the cancellation of approximately 737,500 options. The restricted stock was issued with a purchase price of $0.001 with one sixth of the stock vesting on the grant date and the remainder vesting over three years. As a result of the restricted stock grant, the Company recognized approximately $186,000 and $828,000 of compensation expense in the three and nine months ended December 31, 2001. The remainder of the unearned stock-based compensation will be recognized over the period which the restricted stock vests in accordance with FASB Interpretation No. 28.

In December 2001, the Company issued approximately 375,000 restricted stock units with a fair value of $0.73 per underlying share to an executive officer in exchange for the cancellation of 375,000 options. Approximately 140,000 restricted stock units were vested on the grant date, with the remaining units vesting quarterly through February 2004. As a result of the award, the Company recognized approximately $140,000 of compensation expense in the three months ended December 31, 2001. The remainder of the stock-based compensation will be recognized over the period in which the restricted stock units vest in accordance with FASB Interpretation No. 28.

NOTE 6. RESTRUCTURING CHARGES

In September 2001, management took additional steps to further increase operational efficiencies and to bring costs in line with revenues. These measures included the involuntary termination of approximately 30 employees, approximately 10% of the Company's workforce. As a result, Digital Impact recorded a charge of approximately $100,000 to operations for the quarter ended September 30, 2001. As of September 30, 2001, all of the $100,000 charge had been paid.

In January 2002, management took certain actions to reduce employee headcount in the sales and marketing, development and administrative organizations. These

measures included the involuntary termination of approximately 25 employees. Since the workforce reduction plans were finalized and initiated after the close of the current fiscal quarter, no charges to operations were recognized in the quarter ending December 31, 2001. As a result, charges of approximately $100,000 will be realized in the fourth fiscal quarter ending March 31, 2002.

NOTE 7. CONTINGENCIES

In June 2001, a series of putative securities class actions were filed in United States District Court for the Southern District of New York against certain investment bank underwriters for the Company's initial public offering ("IPO"), the Company, and various of the Company's officers and directors. The complaints, which have been consolidated under the caption Stein v. Digital Impact, Inc., et al., Civil Action No. 01-CV-4942, allege undisclosed and improper practices by the underwriters concerning the allocation of the Company's IPO shares, in violation of the federal securities laws, and seeks unspecified damages on behalf of persons who purchased the Company's stock during the period from November 22, 1999 and December 6, 2000. 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. The Company believes it has meritorious defenses to the claims against it and will defend itself vigorously. In the opinion of management, after consultation with legal counsel and based on currently available information, the ultimate disposition of these matters is not expected to have a material adverse effect on our business, financial condition or results of operations, and hence no amounts have been accrued for these cases.

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

You should read the following discussion of our financial condition and results of operations in conjunction with our financial statements and related notes. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of factors including those discussed in "Certain Factors Which May Impact Future Operating Results," starting on page 16, as well as factors set forth in Digital Impact's Annual Report on Form 10-K for the fiscal year ended March 31, 2001. Any forward-looking statements speak only as of the date such statements are made.

OVERVIEW

Digital Impact, Inc. is one of the premier providers of online direct marketing solutions for enterprises. We were incorporated in California in October 1997 and reincorporated in Delaware in October 1999. Digital Impact's solutions -- Strategy, Customer Acquisition and Customer Marketing -- enable corporations to create and deliver marketing programs that drive revenue, influence behavior and deepen customer relationships. Digital Impact solutions provide deeper customer insight and powerful program execution through a combination of hosted web applications, messaging technology infrastructure and professional services.

In July 2000, we acquired MineShare, Inc. ("MineShare"), a customer intelligence and analysis software company based in Santa Monica, California. The transaction was accounted for using the purchase method of accounting.

Digital Impact generates revenues from the sale of solutions that enable

businesses to proactively communicate with their customers online. Historically, these solutions have primarily consisted of the design and execution of online direct marketing campaigns, the development and execution of customer acquisition programs, and additional services delivered by our professional services organization. In accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," revenue is recognized when online direct marketing campaigns are delivered, provided that there are no remaining significant obligations and collection of the resulting receivable is reasonably assured. Customer set-up fees related to service initiation are deferred and recognized ratably over the term of the customer's master service agreement. Revenue generated from our acquisition services group, which assists clients in growing their email lists through the use of third party list rentals, is recognized when the campaigns are delivered, provided there are no significant remaining obligations and the collection of receivables is reasonably assured. The cost of renting the list is passed through to our clients and hence is offset against the corresponding revenue. Revenue generated from our professional services is recognized as the services are provided.

Cost of revenues consists primarily of expenses relating to the delivery of online direct marketing services, including personnel costs, primarily consisting of our production services and operations staff, the amortization of equipment, purchased and licensed technology, and data center 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 the category, some expenditures, such as compensation, employee benefits, recruiting costs, equipment costs, travel and entertainment costs, facilities costs and third-party professional service fees, occur in each of these categories.

We allocate the total cost for information services and facilities to each functional area that uses the information services and facilities based on its relative headcount. These allocated charges include rent and other facility-related costs, communication charges and depreciation expense for furniture and equipment.

Total operating expenses also include non-cash expenses related to stock-based compensation and amortization of goodwill and purchased intangibles.

As of December 31, 2001 we had 293 full-time employees. In April and September 2001 we realigned our organization with a workforce reduction of approximately 60

and 30 employees, respectively, in order to streamline operations, reduce costs and bring our staffing structure in line with current economic conditions. As a result, costs associated with the April workforce reduction, including severance and other employee-related costs, were accrued in the balance sheet for the fiscal year ended March 31, 2001. Expenses related to the September work force reduction, including severance and other employee expenses, were expensed in the quarter ended September 30, 2001. In January 2002 management reduced the staffing level for the sales, development and administrative organizations. This involved the involuntary termination of approximately 25 employees. Expenses related to payments for severance were not accrued in the quarter ended December 31, 2001. Expense related to the workforce reduction will be realized in the fiscal quarter ending March 31, 2002.

RESULTS OF OPERATIONS

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

	Three months ended December 31,		Nine months ended December 31,	
	2001	2000	2001	2000
Net revenue	100%	100%	100%	100%
Cost of revenue	47%	44%	47%	44%
Gross margin	53%	56%	53%	56%
Operating expenses:				
Research and development	24%	41%	32%	43%
Sales and marketing	35%	41%	43%	44%
General and administrative	19%	25%	23%	27%
Stock-based compensation	3%	5%	8%	15%
Amortization of goodwill and purchased intangibles	4%	20%	4%	13%
Nonrecurring charges	--	--	--	15%
Total operating expenses	85%	132%	110%	157%
Loss from operations	(32%)	(76%)	(57%)	(101%)
Interest income, net	0%	5%	1%	8%
Net loss	(32%)	(71%)	(56%)	(93%)

Three Months Ended December 31, 2001 and 2000

Revenues. Total revenues decreased 16% to $10.3 million for the three months ended December 31, 2001 from $12.2 million for the three months ended December 31, 2000. The decrease was primarily due to a decline in clients, particularly dot-com companies, and a decrease in spending from certain continuing clients from December 2000 to December 2001. These decreases were partially offset by revenue from new large clients, and the expansion of our core service offerings.

Cost of Revenues. Total cost of revenues decreased 9% to $4.8 million for the three months ended December 31,2001 from $5.3 million for the three months ended December 31, 2000. Gross margins declined to 53% for the quarter ended December 31, 2001 from 56% for the quarter ended December 31, 2000, largely due to continued investments in our data center infrastructure and the resulting excess capacity that when spread over our revenue base resulted in lower margins. Margins were favorably impacted by lower consulting costs as we moved towards meeting operating needs with internal personnel.

Research and Development. Research and development expenses consist primarily of personnel related costs, outside contractor costs, and software and hardware maintenance costs. To date, all research and development costs have been expensed as incurred. Research and development expenses declined by 49% to $2.5 million for the quarter ended December 31, 2001 from $4.9 million for the quarter ended December 31, 2000. The decline is primarily a result of a decrease

in personnel costs of approximately $1.1 million, largely related to the reduction in engineering staff related to our realignment initiatives and related overhead, and an $800,000 reduction in outside consulting expenses achieved by utilizing internal resources.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs of our direct sales force and marketing staff and marketing expenses for trade shows, advertisements, promotional activities and media events. Sales and marketing expenses decreased 27% to $3.6 million for the three months ended December 31, 2001 from $4.9 million for the three months ended December 31, 2000. The decrease was primarily due to a decline in personnel costs of approximately $500,000 related to our realignment initiatives and a $550,000 decline in travel, entertainment and program expenses.

General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate operations, including information technology services, finance, accounting, human resources, facilities and legal. General and administrative expenses declined by 39% to $1.9 million for the three months ended December 31, 2001 from $3.1 million for the three months ended December 31, 2000. The overall decrease was primarily the result of a reduction in personnel costs of approximately $450,000 related to a decline in headcount, and a decline in bad debt expense of $400,000 due to lower loss experience from our current client base.

Stock-based Compensation. In connection with the granting of stock options and restricted stock to our employees and the assumption of options related to the acquisition of MineShare, we recorded unearned stock based compensation totaling approximately $18.5 million, net of forfeitures, from inception through December 31, 2001. This amount represents the total difference between the exercise prices of the stock options or the purchase price of restricted stock and the deemed fair market value of the underlying common stock for accounting purposes on the date granted. This amount is included as a component of stockholders' equity and is being amortized on an accelerated basis by charges to operations over the vesting period, consistent with the methods described in FASB Interpretation No. 28.

Stock-based compensation, a noncash expense, decreased 53% to $278,000 for the three months ended December 31, 2001 from $595,000 for the three months ended December 31, 2000. Unearned stock based compensation is recognized over the vesting period, generally three to four years.

Amortization of Goodwill and Purchased Intangibles. During the quarter ended December 31, 2001, we recorded amortization of goodwill and purchased intangibles of $375,000. The goodwill and purchased intangibles relate to the July 31, 2000 acquisition of MineShare and are being amortized over three years.

Other Income and (expense). Other income and (expense) decreased to ($26,000) for the quarter ended December 31, 2001 from $664,000 for the quarter ended December 31, 2000. The decrease is largely due to lower average cash and cash equivalents balances resulting from the use of cash to fund current operations, and lower prevailing interest rates.

Nine Months Ended December 31, 2001 and 2000

Revenues. Total revenues decreased 4% to $28.8 million for the nine months ended December 31, 2001 from $30.0 million for the nine months ended December 31, 2000. The decrease was primarily due to a decline in total clients from December

2000 to December 2001 and a slight decline in the volume of email messages delivered, partially offset by higher revenue from certain continuing clients and expansion of our core service offerings.

Cost of Revenues. Total cost of revenues increased 3% to $13.6 million for the nine months ended December 31, 2001 from $13.2 million for the nine months ended December 31, 2000. The increase was primarily due to higher costs of campaign creation and delivery associated with supporting a higher volume of campaigns, and the expansion of our data center infrastructure. Gross margins declined to 53% for the nine months ended December 31, 2001 from 56% for the nine months ended December 31, 2000, largely due to investments in our data center infrastructure, resulting in excess capacity that when spread over our revenue base resulted in lower margins.

Research and Development. Research and development expenses consist primarily of personnel and related costs, outside contractor costs, and software and hardware maintenance costs. To date, all research and development costs have been expensed as incurred. Research and development expenses declined by 28% to $9.2 million for

the nine months ended December 31, 2001 from $12.8 million for the nine months ended December 31, 2000. The decline is primarily a result of a decrease in personnel costs of approximately $2.0 million, largely related to the decrease in engineering staff associated with our realignment initiatives, and a $2.2 million reduction in outside consulting expenses related to continuing efforts to meet development needs with internal resources. This was partially offset by a $322,000 increase in amortized tangible purchased technology expense related to our MineShare acquisition and a $100,000 increase in allocated corporate overhead and depreciation.

Sales and Marketing. Sales and marketing expenses consist of personnel and related costs primarily for our direct sales force and marketing staff, as well as marketing programs, which include trade shows, advertisements, promotional activities and media events. Sales and marketing expenses decreased 5% to $12.5 million for the nine months ended December 31, 2001 from $13.1 million for the nine months ended December 31, 2000. The decrease was primarily due to a decline in personnel costs of approximately $700,000 related to our realignment initiatives, partially offset by an increase in marketing costs of $169,000.

General and Administrative. General and administrative expenses consist primarily of personnel and related costs for general corporate purposes, including information services, finance, accounting, human resources, facilities and legal. General and administrative expenses declined by 20% to $6.6 million for the nine months ended December 31, 2001 from $8.2 million for the nine months ended December 31, 2000. The decrease was primarily the result of a decrease in personnel costs related to a reduction in headcount and a reduction in bad debt expense.

Stock-based Compensation. In connection with the granting of stock options to our employees and the assumption of options related to the acquisition of MineShare, we recorded unearned stock based compensation totaling approximately $18.5 million, net of forfeitures, from inception through December 31, 2001. This amount represents the total difference between the exercise prices of the stock options or the purchase price of restricted stock and the deemed fair market value of the underlying common stock for accounting purposes on the date these stock options were granted. This amount is included as a component of stockholders' equity and is being amortized on an accelerated basis by charges

to operations over the vesting period of the options, consistent with the methods described in FASB Interpretation No. 28.

Stock-based compensation, a noncash expense, decreased 45% to $2.4 for the nine months ended December 31, 2001 from $4.4 million for the nine months ended December 31, 2000. Unearned stock based compensation is recognized over the vesting period, generally four years.

Amortization of Goodwill and Purchased Intangibles. During the nine months ended December 31, 2001, we recorded amortization of goodwill and purchased intangibles of $1.1 million. The goodwill and purchased intangibles relate to the July 31, 2000 acquisition of MineShare and are being amortized over three years.

Write-off of In-process Research and Development and fixed assets. Nonrecurring charges recorded during the nine months ended December 31, 2000 ($4.6 million) consisted primarily of the write-off of purchased in-process research and development and fixed assets associated with the acquisition of MineShare. The in-process research and development acquired as part of the MineShare acquisition has been incorporated into the Company's product offering.

Other Income and (expense). Other income and (expense) decreased to $299,000 for the nine months ended December 31, 2001 from $2.5 million for the nine months ended December 31, 2000. The decrease is largely due to lower average cash and cash equivalents balances resulting from the use of cash to fund current operations and lower prevailing interest rates.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $5.8 million for the nine months ended December 31, 2001, which was due primarily to a net loss of $16.4 million, a decline of $851,000 in accounts payable and an increase in prepaid expenses and other current assets of $762,000. This was partially offset by noncash charges for amortization of stock-based compensation ($2.4 million) and depreciation and amortization ($6.1 million), as well as a decrease of $3.9 million in accounts receivable related to collection efforts and tighter credit standards. Net cash used in operating activities for the nine months ended December 31, 2000 was $17.1 million, which was due primarily to a net loss of $27.7 million and an increase in accounts receivable of $10.5 million related to higher sales during the period. This was partially offset by non-cash charges including the write-off of in-process research and development associated with the MineShare acquisition ($4.4 million), amortization of stock-based compensation ($4.4 million), and depreciation and amortization ($7.3 million).

Our investing activities used $1.5 million during the nine months ended December 31, 2001, which was attributable primarily to the acquisition of property and equipment related to investments in our data center infrastructure. Cash used in investing activities for the nine months ended December 31, 2000 was $9.9 million, attributable primarily to the acquisition of property and equipment related to significant investments in our data center infrastructure and purchases for new office furniture and equipment for our increased staff.

Financing activities used $1.3 million during the nine months ended December 31, 2001, which was attributable primarily to principal payments on long-term debt of $1.5 million, partially offset by proceeds from the exercise of stock options and the purchase of shares through our employee stock purchase plan. During the nine months ended December 31, 2000, cash provided by financing activities was

$933,000, consisting primarily of the proceeds from the exercise of stock options and the purchase of shares through our employee stock purchase plan. This was offset by principal payments on our long-term debt.

At December 31, 2001, we had $26.3 million in cash and cash equivalents. Amounts borrowed under a leasing line of credit totaled approximately $413,000 at December 31, 2001 and bear interest at rates of between 6.2% and 10.1%. We had $386,000 outstanding under an equipment leasing line, which is secured by the leased assets and bears interest at a rate of 9.5%. We had $470,000 outstanding under an additional equipment leasing line, which is secured by the leased assets and bears interest at a rate of 9.74%. We also had $2.4 million outstanding under a term loan. The loan bears interest at the three-year Treasury rate plus 950 basis points (13.09% as of December 31, 2001) and is secured by the leased assets. Our MineShare subsidiary had approximately $40,000 outstanding under a $50,000 revolving line of credit that bears interest at prime plus 3% (7.75% as of December 31, 2001). We have an equipment loan facility with a maximum borrowing limit of $800,000, which is secured by the equipment of our MineShare subsidiary and bears interest at a rate of 10%. As of December 31, 2001, approximately $205,000 was outstanding under this facility. We have a second equipment loan facility with a borrowing limit of $1,000,000, which is secured by the equipment of our MineShare subsidiary, and bears interest at a rate of 10%. As of December 31, 2001, approximately $32,000 was outstanding under this facility. As of December 31, 2001 no amount is available under either of the equipment leasing lines secured by the assets of our MineShare subsidiary.

Our other principal commitments at December 31, 2001 consisted of obligations under operating leases for facilities and our pledge of $1.9 million of cash as collateral for an outstanding letter of credit. For additional information, see the financial statements. We believe that our existing cash and cash equivalents will be sufficient to satisfy our currently anticipated cash requirements for at least the next twelve months.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 133, or SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 133 establishes new standards of accounting and reporting for derivative instruments and hedging activities. SFAS 133 requires that all derivatives be recognized at fair value in the statement of financial position, and that the corresponding gains or losses be reported either in the statement of operations or as a component of comprehensive income, depending on the type of hedging relationship that exists. SFAS 133, as amended, is effective for fiscal years beginning after June 15, 2000. The Company does not currently hold derivative instruments or engage in hedging activities and hence SFAS 133 did not have a material impact upon the financial statements of the Company.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 141 "Business Combinations," which establishes financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, Business Combinations, and FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises. It requires that all business combinations in the scope of this Statement are to be accounted for using one method, the purchase method. The provisions of this Statement apply to all business combinations initiated after June 30, 2001.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 142 "Goodwill and Other Intangible Assets," which establishes financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, Intangible Assets. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those

acquired in a business combination) should be accounted for in financial statements upon their acquisition, and after they have been initially recognized in the financial statements. The provisions of this Statement are effective starting with fiscal

years beginning after December 15, 2001. Early adoption is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued. Accordingly, the Company has elected not to early adopt SFAS No.142 beginning with the first quarter of fiscal 2002. Upon adoption of FAS 142, the Company will reclassify the amount relating to assembled workforce (currently $1.4 million) from intangible assets to goodwill and will no longer amortize goodwill.

On October 3, 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supercedes SFAS No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends APB Opinion No. 30, "Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for the Company for all financial statements issued in 2002. The adoption of SFAS No. 144 is not expected to have a material impact on the Company's financial statements.

CERTAIN FACTORS WHICH MAY IMPACT FUTURE OPERATING RESULTS

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

BECAUSE OF OUR LIMITED OPERATING HISTORY AND THE EMERGING NATURE OF THE ONLINE DIRECT MARKETING INDUSTRY, ANY PREDICTIONS ABOUT OUR FUTURE REVENUES AND EXPENSES MAY NOT BE AS ACCURATE AS THEY WOULD BE IF WE HAD A LONGER BUSINESS HISTORY, AND WE CANNOT DETERMINE TRENDS THAT MAY AFFECT OUR BUSINESS.

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

OUR OPERATING RESULTS HAVE VARIED SIGNIFICANTLY IN THE PAST AND ARE LIKELY TO

VARY SIGNIFICANTLY FROM PERIOD TO PERIOD, AND OUR STOCK PRICE MAY DECLINE IF WE FAIL TO MEET THE EXPECTATIONS OF ANALYSTS AND INVESTORS.

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

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. Because we do experience these effects, analysts and investors may not be able to predict our quarterly or annual operating results. If we fail to meet expectations of analysts and investors, our stock price could decline.

IF BUSINESSES AND CONSUMERS FAIL TO ACCEPT ONLINE DIRECT MARKETING AS A MEANS TO ATTRACT NEW CUSTOMERS, DEMAND FOR OUR SERVICES MAY NOT DEVELOP AND THE PRICE OF OUR

STOCK COULD DECLINE.

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

THE LOSS OF A MAJOR CLIENT COULD RESULT IN LOWER THAN EXPECTED REVENUES.

The loss of a major client could harm our business. While only one client accounted for more than 10% of our revenues for the quarter ended December 31, 2001, the loss of a major client could have a material adverse effect on our business and results of operations. Additionally, some Internet-based businesses have recently been experiencing financial problems. While the majority of our clients are not Internet-based businesses, the loss of a number of these clients could have a material adverse effect on our business and our results of operations.

THE ONLINE DIRECT MARKETING INDUSTRY IS HIGHLY COMPETITIVE, AND IF WE ARE UNABLE TO COMPETE EFFECTIVELY, THE DEMAND FOR, OR THE PRICES OF, OUR SERVICES MAY DECLINE.

The market for online direct marketing is highly competitive, rapidly evolving and experiencing rapid technological change. Intense competition may result in price reductions, reduced sales, gross margins and operating margins, and loss of market share. Our principal competitors include providers of online direct marketing solutions such as DoubleClick, , Responsys, Cheetahmail, CMGI's Yesmail (through its recent acquisition of Post Communications), eDialog and Clickaction, as well as the in-house information technology departments of our existing and prospective clients.

In addition, we expect competition to persist and intensify in the future, which could harm our ability to increase sales and maintain our prices. In the future, we may experience competition from Internet service providers, advertising and direct marketing agencies and other large established businesses. possessing large, existing customer bases, substantial financial resources and established distribution channels and could develop, market or resell a number of online

direct marketing solutions. These potential competitors may also choose to enter, or have already entered, the market for online direct marketing by acquiring one of our existing competitors or by forming strategic alliances with a competitor.

Many of these potential competitors have broad distribution channels and they may bundle competing products or services. As a result of future competition, the demand for our services could substantially decline. Any of these occurrences could harm our ability to compete effectively.

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 services and our ability to provide comprehensive online direct marketing expertise. Our main offices are located in the San Francisco Bay Area, where competition for personnel with Internet-related technology and marketing skills is intense. If we fail to identify, attract, retain and motivate these highly skilled personnel, we may be unable to successfully introduce new services or otherwise implement our business strategy. As a public company we face greater difficulty attracting and retaining personnel than we did as a private company.

WE RELY ON THE SERVICES OF OUR FOUNDERS AND OTHER KEY PERSONNEL, WHOSE KNOWLEDGE OF OUR BUSINESS AND TECHNICAL EXPERTISE WOULD BE EXTREMELY DIFFICULT TO REPLACE.

Our future success depends to a significant degree on the skills, experience and efforts of our senior management. In particular, we depend upon the continued services of our co-founders William Park, our Chief Executive Officer, and Gerardo Capiel, our Chief Technology Officer, whose vision for our company, knowledge of our business and technical expertise would be extremely difficult to replace. In addition, we have not obtained life insurance benefiting Digital Impact covering any of our key employees. If any of our key employees left or was seriously injured and unable to work and we were unable to find a qualified replacement, the level of services we are able to provide could decline or we could be otherwise unable to execute our business strategy.

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IF THE DELIVERY OF OUR EMAIL MESSAGES IS LIMITED OR BLOCKED, THEN OUR CLIENTS MAY DISCONTINUE THEIR USE OF OUR SERVICES.

Our business model relies on our ability to deliver emails over the Internet through Internet service providers and to recipients in major corporations. In particular, a significant percentage of our emails are sent to recipients who use America Online. We do not have, and we are not required to have, an agreement with America Online to deliver emails to their customers. America Online uses a proprietary set of technologies to handle and deliver email and the value of our services will be reduced if we are unable to provide emails compatible with these technologies. In addition, America Online and other Internet service providers are able to block unwanted messages to their users. If these companies 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 our clients may discontinue their use of our services.

OUR FACILITIES AND SYSTEMS ARE VULNERABLE TO NATURAL DISASTERS AND OTHER UNEXPECTED EVENTS, AND ANY OF THESE EVENTS COULD RESULT IN AN INTERRUPTION OF OUR ABILITY TO EXECUTE OUR CLIENTS' ONLINE DIRECT MARKETING CAMPAIGNS.

We depend on the efficient and uninterrupted operations of our data center and hardware systems. Our data center and hardware systems are located in Northern

California, an area susceptible to earthquakes. Our data center and hardware systems are also vulnerable to damage from fire, floods, power loss, telecommunications failures, and similar events. If any of these events results in damage to our data center or systems, we may be unable to execute our clients' online direct marketing campaigns until the damage is repaired, and may accordingly lose clients and revenues. In addition, 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 ADEQUATELY PROTECT OUR INTELLECTUAL PROPERTY, THIRD PARTIES COULD USE OUR INTELLECTUAL PROPERTY WITHOUT OUR CONSENT.

Our ability to successfully compete is substantially dependent upon our internally developed technology and intellectual property, which we protect through a combination of copyright, trade secret and trademark law, and contractual obligations. We have no issued patents and have two U.S. patent applications pending. We have several registered U.S. trademarks and have several more applications pending in the U.S., Europe and Japan. We may not be able to adequately protect our proprietary rights. Unauthorized parties may attempt to obtain and use our proprietary information. Policing unauthorized use of our proprietary information is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

IF WE ARE UNABLE TO SAFEGUARD THE CONFIDENTIAL INFORMATION IN OUR DATA WAREHOUSE, OUR REPUTATION MAY BE HARMED AND WE MAY BE EXPOSED TO LIABILITY.

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

reputation may be harmed if we lose customer information maintained in our data warehouse due to systems interruptions or other reasons.

ACTIVITIES OF OUR CLIENTS COULD DAMAGE OUR REPUTATION OR GIVE RISE TO LEGAL CLAIMS AGAINST US.

Our clients' promotion of their products and services may not comply with federal, state and local laws, including but not limited to laws and regulations

surrounding the Internet. 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 substantial fines or penalties, redesign our business methods, discontinue some of our services or otherwise expend resources to avoid liability.

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

NEW REGULATION OF, AND UNCERTAINTIES REGARDING THE APPLICATION OF EXISTING LAWS AND REGULATIONS TO, ONLINE DIRECT MARKETING AND THE INTERNET COULD PROHIBIT, LIMIT OR INCREASE THE COST OF OUR BUSINESS.

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

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

INTERNET-RELATED STOCK PRICES ARE ESPECIALLY VOLATILE AND THIS VOLATILITY MAY DEPRESS OUR STOCK PRICE.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For the period from our inception through December 31, 2001, we provided our services to clients primarily in the United States. As a result, our financial results have not been directly affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. The majority of our sales are currently denominated in U.S. dollars. During the quarter ended June 30, 2000, we established a subsidiary in the United Kingdom

which has had minimal operations to date. As the operations of this subsidiary

expand, our future operating results could be directly impacted by changes in foreign currency exchange rates or economic conditions in this region.
Our exposure to market risk for changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio and on the increase or decrease in the amount of interest expense we must pay on our outstanding debt instruments. The risk associated with fluctuating interest expense is limited, however, to the exposure related to those debt instruments and credit facilities which are tied to market rates. We do not plan to use derivative financial instruments in our investment portfolio. We plan to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We plan to mitigate default risk by investing in high-credit quality securities.

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 Stein v. Digital Impact, Inc., et al., Civil Action No. 01-CV-4942, allege undisclosed and improper practices by the underwriters concerning the allocation of the Company's IPO shares, in violation of the federal securities laws, and seeks unspecified damages on behalf of persons who purchased the Company's stock during the period from November 22, 1999 and December 6, 2000. 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. The Company believes it has meritorious defenses to the claims against it and will defend itself vigorously. In the opinion of management, after consultation with legal counsel and based on currently available information, the ultimate disposition of these matters is not expected to have a material adverse effect on our business, financial condition or results of operations, and hence no amounts have been accrued for these cases.

ITEM 2. CHANGE IN SECURITIES AND USE OF PROCEEDS

In November 1999, we completed our initial public offering of 5,175,000 shares of our common stock, which included 675,000 shares in connection with the exercise of the underwriters' overallotment option, at $15 per share. The managing underwriters in the offering were Credit Suisse First Boston; Hambrecht & Quist; Donaldson, Lufkin & Jenrette; and U.S. Bancorp Piper Jaffray. The sale of our shares of common stock in the offering was registered under the Securities Act of 1933, as amended, on a Registration Statement on Form S-1 (Reg. No. 333-87299) that was declared effective by the Securities and Exchange Commission on November 22, 1999. The aggregate offering amount including the overallotment exercise was approximately $77.6 million. We incurred expenses of approximately $6.8 million, of which approximately $5.4 million represented underwriting discounts and commissions and approximately $1.4 million represented other expenses related to the offering.

Currently, we have placed the remaining net proceeds (approximately $26.3 million) from the offering in short-term, interest bearing, investment grade

securities. During the nine months ended December 31, 2001, we used approximately $8.7 million of the net proceeds to fund our general operations. We expect to use the remaining offering net proceeds for working capital and general corporate purposes, including continued investment in the development of our current and future online direct marketing services, the expansion of our sales and marketing activities, and investment in our infrastructure. Additionally, we may use a portion of the net proceeds to acquire or invest in complementary products, technologies, or businesses.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Exhibits	Description
10.1	Employment agreement by and between Registrant and Kevin Johnson

Reports on Form 8-K

None

SIGNATURES

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

Dated: February 13, 2002

DIGITAL IMPACT, INC.
(Registrant)

/S/ WILLIAM PARK

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

/S/ DAVID OPPENHEIMER

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

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EXHIBIT INDEX

Exhibits	Description
10.1	Employment agreement by and between Registrant and Kevin Johnson

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