DIGITAL IMPACT INC /DE/
Form 10-K
June 07, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended March 31, 2002

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

Commission File Number: 000-27787

DIGITAL IMPACT, INC.

(Exact name of the 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:

Title of each class	Name of each exchange on which registered
None	None

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

Common Stock, $0.001 par value
(Title of Class)

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 o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

The aggregate market value of the voting Common Stock held by non-affiliates of the Registrant, based upon the closing sale price of the Common Stock on June 3, 2002 as reported on the Nasdaq National Market, was approximately $25.4 million. Shares of Common Stock held by each officer and director and by each person who owns 5% or more of the outstanding Common Stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of June 3, 2002, the Registrant had outstanding approximately 30.0 million shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our definitive Proxy Statement for our 2002 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission within 120 days after the end of our fiscal year, are incorporated by reference into Part III hereof.

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ANNUAL REPORT
For the Year Ended March 31, 2002

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PART I

Forward-Looking Information

THIS REPORT CONTAINS FORWARD-LOOKING STATEMENTS RELATED TO FUTURE EVENTS AND OUR FUTURE PERFORMANCE WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES AND EXCHANGE ACT OF 1934, AS AMENDED. STOCKHOLDERS ARE CAUTIONED THAT SUCH STATEMENTS INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS AND TIMING OF CERTAIN EVENTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF CERTAIN FACTORS, INCLUDING, BUT NOT LIMITED TO, THOSE SET FORTH UNDER RISK FACTORS AND ELSEWHERE IN THIS REPORT AND IN OUR OTHER PUBLIC FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION. IT IS ROUTINE FOR INTERNAL PROJECTIONS AND EXPECTATIONS TO CHANGE AS THE YEAR OR EACH QUARTER IN THE YEAR PROGRESSES, AND THEREFORE IT SHOULD BE CLEARLY UNDERSTOOD THAT THE INTERNAL PROJECTIONS AND BELIEFS UPON WHICH WE BASE OUR EXPECTATIONS MAY CHANGE PRIOR TO THE END OF EACH QUARTER OR THE YEAR. ALTHOUGH THESE EXPECTATIONS MAY CHANGE, WE MAY NOT INFORM YOU IF THEY DO. OUR COMPANY POLICY IS GENERALLY TO PROVIDE OUR EXPECTATIONS ONLY ONCE PER QUARTER, BUT WE MAY CHOOSE NOT TO UPDATE THAT INFORMATION UNTIL THE NEXT QUARTER EVEN IF CIRCUMSTANCES CHANGE.

Item 1. *Business*

Overview

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

The IMPACT™ hosted application (IMPACT) forms the core of our online direct marketing solutions. Leveraging a highly scalable, hosted technology infrastructure, the IMPACT application facilitates every aspect of online direct marketing including data management, marketing analytics, campaign management and message delivery. IMPACT is the first online direct marketing application built specifically for enterprise marketing teams to collaborate across departments, geographies and external agencies to quickly analyze, design, implement and execute complex targeted email marketing campaigns.

Enterprise marketers face two major challenges in their email marketing programs: easily accessing and analyzing large quantities of cross-channel customer information, often stored in CRM databases, as well as coordinating the time-sensitive email campaign process across marketing groups, corporate divisions and outside agencies. IMPACT solves these problems by providing round-trip integration of sophisticated marketing analytics and collaborative email campaign management. Marketers can quickly access and analyze a wide range of cross-channel CRM data, identify new customer segments, easily create and deliver email campaigns to those segments, and track and measure the results, all in one application. Through its built-in workflow, and role and task management, IMPACT lets marketers control and accelerate the process of creating coordinated email marketing campaigns with collaboration among all stakeholders.

We provide our technology through a flexible outsourcing model minimizing systems and application support burden and giving clients a range of full-service and self-service alternatives. Many of our clients contract for a combination of professional services and industry-leading technology, ensuring that we jointly create and implement online direct marketing campaigns that achieve optimal results.

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On July 31, 2000 we acquired MineShare, Inc. (MineShare), a customer intelligence and analysis company based in Santa Monica, California, in exchange for approximately 1,855,700 shares of our common stock. Additionally, we assumed MineShare s outstanding stock options and warrants and reserved approximately 132,700 shares of our common stock for issuance upon exercise of these options and warrants. The acquisition was effected by means of a merger pursuant to which a wholly owned subsidiary of Digital Impact was merged with and into MineShare, with MineShare as the surviving corporation. The acquisition has been accounted for as a purchase.

Solutions

We provide comprehensive solutions for creating and executing online direct marketing programs. Our solutions are designed to enable marketers to build the foundation required to develop online direct marketing programs, reach new customers, and maximize the value of existing customers. Our solutions consist of the following offerings:

IMPACT TM

IMPACT is a premier hosted online direct marketing application built specifically to address the complex needs of global enterprise marketers. IMPACT provides round-trip integration of sophisticated marketing analytics with collaborative email campaign management. Marketers can quickly access and analyze a wide range of cross-channel CRM data, identify new client-customer segments, easily create and deliver email campaigns to those segments, and track and measure the results, all in one application.

Campaign Services

Campaign Services provides marketers with an account team to efficiently execute their online direct marketing programs. Based upon a marketer s guidance, the Campaign Services team targets, tests and executes email marketing campaigns utilizing the IMPACT hosted application. Marketers maintain control and visibility over the entire process.

Program Services

Program Services provides marketers with an expert team designed to proactively build and manage their online direct marketing programs around their email marketing goals. The Program Services team delivers insight, analysis and management to optimize the value of online customer relationships.

Customer Acquisition

Customer acquisition is a full service marketing offering that enables clients to cost-effectively reach new prospects and drive online revenue by converting prospects into customers. Digital Impact helps clients achieve superior results by providing access to a rich base of prospect sources, negotiating exceptional rates and optimizing campaigns to reach the highest value customers. Our Customer Acquisition clients receive full-service program management, including strategic media plan development, comprehensive testing and results analysis.

Professional Services

Professional services can be utilized by clients to enhance marketing programs and improve results. Digital Impact offers clients services to fulfill online direct marketing needs in each of the following categories: Strategy, Analysis, Data Management, Solutions Engineering, Web Development, Creative and Design and Media Planning.

Research and Development

We believe that strong product development capabilities are essential to our strategy of enhancing our core technology, developing additional applications incorporating that technology and maintaining the

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competitiveness of our product and service solutions. Digital Impact invested significant time and resources in creating a structured process for undertaking all product development. This process involves several functional groups at all levels within our organization and is designed to provide a framework for defining and addressing the activities required to bring product concepts and development projects to market successfully. For the fiscal year ended March 31, 2002 we spent $11.2 million on activities related to research and development.

Sales and Marketing

We sell our products and services in the United States through a sales and marketing organization that consisted of 67 employees as of March 31, 2002. These employees are primarily located at our headquarters in San Mateo, California and also in our offices in Chicago and New York City. We also maintain a sales and client services organization of 6 employees in London, England supporting the European region.

Clients

Our clients consist of a diverse group of companies operating in many industries primarily throughout the United States, ranging from Fortune 1000 to small private companies. For the year ended March 31, 2002, one customer, Hewlett Packard, accounted for more than 10% of our total revenues and outstanding receivables, representing 11% of total revenues and 17% of outstanding receivables at March 31, 2002.

Competition

The market for online direct marketing services is highly competitive and rapidly evolving and experiences rapid technological change. We expect competition to increase significantly in the future because of the attention the Internet has received as a means of advertising and direct marketing and because there are limited barriers to entry into our market.

We believe that the factors on which we successfully compete include:

Credibility of clients and their willingness to act as references.

Quality of online direct marketing services.

Technology-enhanced service offerings.

Sophistication and reliability of technology.

Speed of implementation of online direct marketing campaigns.

Cost-effective online direct marketing solutions.

Measurable results.

Although we believe that our solutions currently compete favorably as to each of these factors, our market is relatively new and is evolving rapidly. We may not be able to maintain our competitive position against current and potential competitors.

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.

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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.

Intellectual Property

We rely upon a combination of patent, copyright, trade secret and trademark laws to protect our intellectual property. We currently have no issued U.S. patents and two U.S. patent applications pending.

In addition, we have several registered U.S. trademarks and several more trademark applications pending in the U.S., Europe and Japan. Although we rely on patent, copyright, trade secret and trademark law to protect our technology, we believe that factors such as the technological and creative skills of our personnel, new product developments, frequent product enhancements and reliable product maintenance are more essential to establishing and maintaining a technology leadership position. Others may develop technologies that are similar or superior to our technology.

Government Regulation

Legislation has been enacted in several states restricting the sending of unsolicited commercial email. The federal government, foreign governments and several other states are considering, or have considered, similar legislation. Although the provisions of these current and contemplated laws vary, they generally limit or prohibit both the transmission of unsolicited commercial emails and the use of forged or fraudulent routing and header information. Some states, including California, require that unsolicited commercial emails include opt-out instructions and that senders of such emails honor any opt-out requests. We believe that our current suite of services are not affected by such legislation because the list management practices that we espouse to our clients are intended to prevent the sending of unsolicited commercial email. We cannot assure you that future legislation or the application of existing legislation will not harm our business.

Seasonality

The traditional direct marketing industry has typically generated lower revenue during the summer months and higher revenue during the calendar year-end months. We believe our business is affected by similar revenue fluctuations, but we are unable to isolate and predict the magnitude of these effects.

Employees

As of March 31, 2002, we had a total of 267 full-time employees. Of the total number of employees, 44 were engaged in research and development, 67 in sales, marketing and business development, 118 in account management, professional services, production and technical support and 38 in operations, finance, and administration.

Our future performance depends in significant part upon the continued service of our key technical, sales and senior management personnel. Our future success also depends on our continuing ability to attract, train and retain highly qualified technical, sales and managerial personnel. None of our employees is represented by a labor union. We have not experienced any work stoppages and consider our relations with our employees to be good.

Item 2. ***Properties***

Our principal executive offices are located in San Mateo, California, where we lease approximately 34,000 square feet under three leases that expire in dates ranging from 2005 to 2007. Digital Impact also leases office space in New York City, Chicago and London for local sales and client service personnel, and in Cupertino and Santa Monica, California for research and development staff and data center personnel.

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Item 3. ***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 seek unspecified damages on behalf of persons who purchased the Company s stock during the period from November 22, 1999 to 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 4. ***Submission of Matters to a Vote of Security Holders***

Not applicable.

Item 4a. ***Executive Officers of Registrant***

The following table sets forth certain information regarding the executive officers of the Company as of June 3, 2002:

Name	Age	Position
William Park	34	President, Chief Executive Officer and Chairman of the Board of Directors
Gerardo Capiel	33	Chief Technology Officer and Director
David Oppenheimer	45	Senior Vice President, Finance, Chief Financial Officer and Treasurer
Kevin Johnson	37	Senior Vice President, Client Services
John Ouren	32	Senior Vice President, Professional Services
Dave Kleinberg	43	Senior Vice President, Marketing
Ronald Rasmussen	40	Senior Vice President, Engineering and Operations

William Park has served as our Chief Executive Officer since July 1999 and serves as President and Chairman of our Board of Directors, positions he has held since he co-founded Digital Impact in October 1997. From July 1996 until November 1996, Mr. Park was Director of Profile Marketing for NetAngels, an Internet company focused on web personalization technologies. From 1989 to 1994, Mr. Park held a variety of marketing positions at ZAI*NET Software, Inc., an enterprise software company, where he became Vice President of Marketing in 1993. Mr. Park holds a B.A. from the University of Pennsylvania and an M.B.A. from Stanford University.

Gerardo Capiel has served as our Chief Technology Officer and as a member of our Board of Directors since he co-founded Digital Impact in October 1997. From August 1996 to August 1997, Mr. Capiel was Director of Internet/ Internet Solutions for Altro Solutions, an information technology and business process consulting firm. Mr. Capiel holds a B.S. in engineering systems and computation from the Massachusetts Institute of Technology and an M.B.A. from Stanford University.

David Oppenheimer has served as our Senior Vice President, Finance, Chief Financial Officer and Treasurer since October 2000. From November 1997 to July 1999, Mr. Oppenheimer was Vice President, Finance for Autodesk, Inc., a supplier of design and visual effect software. From January 1995 to November 1997, Mr. Oppenheimer held several positions with AlliedSignal, Inc., an advanced technology and manufacturing company, including Chief Financial Officer of AlliedSignal Electronic Materials, Vice President of

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Finance for AlliedSignal Aerospace Services and Controller of AlliedSignal Engines. From August 1985 to January 1995, Mr. Oppenheimer was employed by United Airlines, most recently as Division Controller. Mr. Oppenheimer holds a B.S. in mechanical engineering from State University of New York, Buffalo and an M.B.A. from the University of California, Berkeley.

Kevin Johnson has served as our Senior Vice President, Client Services since December 2001. Prior to joining Digital Impact, Mr. Johnson was the Senior Vice President of Client Services at Netcentives, a leading provider of relationship marketing technology and services. Mr. Johnson managed all aspects of Netcentives email marketing group (formerly Post Communications). Prior to his tenure at Netcentives, Mr. Johnson co-founded and served as CEO of Passporta.com, an e-commerce business providing hard-to-find local specialties from around the world and he spent five years with the Boston Consulting Group, where he provided strategic and operating expertise to leading multinational companies. Mr. Johnson holds a B.A. from the University of California, Berkeley and an M.B.A. from Stanford University.

John Ouren has served as our Senior Vice President, Professional Services since April 2002, our Senior Vice President of Worldwide Sales from March 2001 to April 2002, Vice President of Professional Services from September 2000 to February 2001 and Director of Strategic and Analytic Services from November 1999 to August 2000. Prior to joining Digital Impact, Mr. Ouren served as an engagement manager in the Silicon Valley office of McKinsey and Company, where he lead the company s Electronic Commerce Special Initiative and Financial Institutions Group. Mr. Ouren holds a B.S. in electrical engineering from the University of Texas and an M.B.A. from Stanford University.

David Kleinberg has served as our Senior Vice President, Marketing since November 2000. From August 1999 to November 2000, Mr. Kleinberg was Founder and CEO of eStar, a provider of online celebrity information. From November 1995 to July 1999, Mr. Kleinberg served as co-founder and Executive Vice President of Products for NetObjects, a leading provider of web site building technology. From September 1992 to November 1995, Mr. Kleinberg served as co-founder and Executive Vice President, Marketing and Sales for Rae Technology, Inc., a custom software development company. Mr. Kleinberg has also held various director-level positions with Macromedia and Apple Computer. Mr. Kleinberg holds a B.A. in English literature and American Government from Georgetown University and an M.B.A. from Stanford University.

Ronald Rasmussen has led our Engineering and Operations group since October 1999, first as Vice President and, since October 2000, as Senior Vice President. From September 1997 to October 1999, Mr. Rasmussen served as Vice President, Engineering and Product Development of The Santa Cruz Operation Inc., a business systems software company. From 1993 to September 1997, Mr. Rasmussen served as Director of Engineering of The Santa Cruz Operation Inc. Prior to that, Mr. Rasmussen served in a variety of senior software engineering positions for Hewlett-Packard. Mr. Rasmussen holds a B.A. in economics and computer science from the University of California, Santa Cruz.

PART II

Item 5. a) ***Market for the Registrant s Common Equity and Related Stockholder Matters***

Our common stock has been quoted on the Nasdaq National Market under the symbol DIGI since our initial public offering on November 23, 1999. The following table sets forth, for the periods indicated, the high and low sales prices per share of common stock as reported on the Nasdaq National Market.

	High	Low
Fiscal Year 2001:		
First quarter (from 4/01/00 6/30/00)	26.50	8.00
Second quarter	19.75	6.50
Third quarter	6.81	1.66
Fourth quarter	4.75	1.19
Fiscal Year 2002:		
First quarter (from 4/01/01 6/30/01)	2.10	1.10
Second quarter	1.60	0.69
Third Quarter	1.50	0.64
Fourth Quarter	3.71	1.47

On March 28, 2002, the last sale price of our common stock reported by the Nasdaq National Market was $2.99 per share. On June 3, 2002, the last sale price of our common stock reported by the Nasdaq National Market was $1.80 per share. As of June 3, 2002, the approximate number of common stockholders of record was 147.

Digital Impact has never declared or paid any cash dividends on its capital stock. Digital Impact currently intends to retain its future earnings, if any, to fund the development and growth of its business and, therefore, does not anticipate paying any cash dividends in the foreseeable future. Furthermore, our credit agreements place restrictions on our ability to pay dividends.

(b) *Report of Offering Securities and Use of Proceeds Therefrom:*

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 over-allotment 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.

(c) *Unregistered Sales of Equity Securities.*

On or about February 20, 2001, pursuant to a Note Conversion Agreement between us and certain holders of notes issued by MineShare, Inc., we converted notes with an aggregate unpaid principal and interest totaling approximately $600,000 into approximately 190,000 shares of our common stock. The transaction was exempt from registration by reason of Section 4(2) of the Securities Act of 1933. The sales were made in private transactions without general solicitation or advertising. Digital Impact believes that each purchaser (i) was an accredited investor with access to all relevant information necessary, (ii) was acquiring Digital Impact common stock solely for its own account and for investment, and (iii) does not intend to offer, sell or dispose of such shares except in compliance with the Securities Act of 1933.

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Item 6. ***Selected Consolidated Financial Data***

	Fiscal year ended March 31,				October 16, 1997 (date of inception) to March 31, 1998
	2002	2001	2000	1999	
	(In thousands, except per share data)				
Statement of Operations Data					
Revenues	$ 39,038	$ 40,153	$ 12,991	$ 1,307	$ 4
Gross margin	21,045(1)	22,317(2)	6,813	633	
Loss from operations	(19,975)(1)	(59,763)(2)	(23,130)	(3,311)	(104)
Net loss per common share basic and diluted*	$ (0.70)	$ (2.33)	$ (2.28)	$ (2.86)	$(0.45)

	March 31,				
	2002	2001	2000	1999	1998
Balance Sheet Data					
Cash, cash equivalents and short-term investments	$25,588	$35,038	$68,073	$2,864	$1,032
Total assets	49,633	69,019	81,102	6,314	1,078
Long-term debt and capital lease obligations	1,324	2,653	726	691	
Stockholders equity	38,889	55,555	73,530	4,370	1,056

* For the number of shares used in this calculation for fiscal 2002, 2001 and 2000, see Note 2 to the Consolidated Financial Statements.

(1) Loss from operations and net loss per common share include a restructuring charge of $1.2 million and a fixed asset write-off of $0.6 million

(2) Loss from operations and net loss per common share include a goodwill impairment charge of $19.0 million and the write-off of acquired in-process research and development and fixed assets of $4.6 million

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Item 7. ***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 19. Any forward-looking statements speak only as of the date such statements are made.

Overview

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

In July 2000, we completed an acquisition of MineShare, Inc. (MineShare), a customer intelligence and analysis company based in Santa Monica, California, under which MineShare became our wholly owned subsidiary. The transaction was accounted for using the purchase method of accounting. The purchase price was approximately $31.9 million. In connection with the acquisition, we recorded goodwill and intangible assets of approximately $30.9 million, which we are amortizing over a period of three years. During the quarter ended March 31, 2001, we performed an impairment assessment of the identified intangibles and goodwill recorded in connection with the acquisition of MineShare. As a result of our review, we recorded an impairment charge of $19.0 million relating to goodwill. Please refer to Recent Accounting Pronouncements below for a description of accounting methodology for goodwill and intangibles beginning April 1, 2002.

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

As of March 31, 2002 the Company had 267 full-time employees, 31% fewer than the 389 employed on March 31, 2001. We restructured our organization throughout fiscal 2002 in order to streamline operations, reduce costs and bring our staffing structure in line with current economic conditions.

Critical Accounting Policies and Estimates

Digital Impact s consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. On an on-going basis, management evaluates its estimates and evaluations, including those related to the allowance for doubtful accounts, intangible assets, restructuring costs and contingencies and litigation. Management bases its estimates and evaluations on historical experience and various factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

revenue recognition;

estimating valuation allowances, specifically the allowance for doubtful accounts; and

valuation of long-lived assets and goodwill;

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

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

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

Allowance for doubtful accounts. The preparation of financial statements requires our management to make estimates and assumptions that affect the reported amount of assets and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Specifically, management must make estimates of the uncollectable portion of our accounts receivable. Management specifically analyzes accounts receivable and analyzes historical bad debt experience, customer concentrations, customer credit worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our accounts receivable balance was $8.2 million, net of allowance for doubtful accounts of $697,000, as of March 31, 2002.

Valuation of long-lived assets and goodwill. We assess the impairment of identified intangibles, long-lived assets and related goodwill and enterprise level goodwill annually and whenever events or a change

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in circumstances indicate the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period of time; and

our market capitalization relative to net book value.

When we determine that the carrying value of intangible assets, long-lived assets and related goodwill and enterprise level 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. Net intangible assets, long-lived assets, and goodwill amounted to $12.3 million as of March 31, 2002.

On April 1, 2002, we adopted Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets and as a result we will reclassify $1.2 million related to assembled workforce to goodwill and cease amortizing the goodwill balance of $2.0 million. We are required to perform an initial impairment review of our goodwill in the first half of fiscal 2003 and an annual impairment review thereafter. We currently do not expect to record an impairment charge upon the completion of an initial, preliminary impairment review.

QUARTERLY RESULTS OF OPERATION

The following table sets forth certain unaudited consolidated quarterly statement of operations data for the eight quarters ended March 31, 2002. This information is unaudited, but in the opinion of management, it has been prepared on substantially the same basis as the audited consolidated financial statements appearing elsewhere in this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts stated below to present fairly the unaudited consolidated quarterly results of operation. The consolidated quarterly data should be read in conjunction with our audited consolidated financial statements and the notes to such statements appearing elsewhere in this report. The results of operations for any quarter are not necessarily indicative of the results of operations for any future period.

Fiscal Quarter Ended	Revenues	Gross Profit	Loss From Operations	Net Loss	Weighted Average Common Shares Basic and Diluted	Basic and Diluted Net Loss per Common Share
			(In thousands, except per share data)			
2002						
June 30	$10,006	$5,446	$ (6,799)	$ (6,615)	26,930	$(0.25)
September 30	8,420	4,208	(6,692)	(6,551)	27,610	(0.24)
December 31	10,329	5,489	(3,181)	(3,207)	28,340	(0.11)
March 31	10,283	5,902	(3,303)	(3,305)	28,960	(0.11)
2001						
June 30	$ 8,474	$4,761	$ (7,024)	$ (6,056)	22,160	$(0.27)
September 30	9,371	5,217	(14,009)	(13,141)	24,010	(0.55)
December 31	12,156	6,830	(9,156)	(8,492)	25,080	(0.34)
March 31	10,152	5,509	(29,574)	(29,042)	26,060	(1.11)

In the fourth quarter of fiscal 2002, Digital Impact recorded a restructuring charge of $1.2 million. The components of the charge included the involuntary termination of 24 employees, the consolidation of leased office space in Cupertino, CA, and the write-off of related fixed assets. (See Note No. 8 to the Consolidated

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Financial Statements.) Also in the fourth quarter of 2002, Digital Impact realized a loss of approximately $600,000 related to the disposal of fixed assets.

In the fourth quarter of fiscal 2001, Digital Impact recognized approximately $19.0 million in impairments associated with the write down of the goodwill generated in its acquisition of MineShare. (See Note No. 3 to the Consolidated Financial Statements.)

In the second quarter of fiscal 2001, Digital Impact recognized approximately $4.6 million in write-offs in the acquisition of MineShare related to the purchase of in-process research and development and fixed assets.

The amount and timing of our operating expenses will vary from quarter to quarter depending on our level of actual and anticipated business activity. Our revenues and operating results are difficult to forecast and will fluctuate, and we believe you should not rely on them as an indication of future performance.

Results of Operations

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

	Fiscal year ended March 31,		
	2002	**2001**	**2000**
Net revenues	100%	100%	100%
Cost of revenues	46	44	48
Gross margin	54	56	52
Operating expenses:			
Research and development	29	44	57
Sales and marketing			