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

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2003

OR

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

For the transition period from ______ to ______

Commission File Number: 000-27787

DIGITAL IMPACT, INC.

(Exact name of registrant as specified in its charter)

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

177 Bovet Road
San Mateo, California 94402
(Address of principal executive offices)

Telephone Number (650) 356-3400
(Registrant s telephone number, including area code)

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

Yes [X] No [ ]

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

Yes [ ] No [X]

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

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

DIGITAL IMPACT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2003	2002	2003	2002
Revenues	$11,509	$11,490	$33,361	$33,136
Cost of revenues	4,921	4,536	14,444	13,391
Gross profit	6,588	6,954	18,917	19,745
Operating expenses:				
Research and development	1,118	1,722	3,840	5,440
Sales and marketing	3,055	3,486	9,033	10,493
General and administrative	1,943	1,824	5,381	5,424
Stock-based compensation	36	15	78	443
Amortization of purchased intangibles		161	214	483
Total operating expenses	6,152	7,208	18,546	22,283
Income (loss) from operations	436	(254)	371	(2,538)
Other income and (expense), net	53	(43)	(67)	(115)
Net income (loss)	$ 489	$ (297)	$ 304	$ (2,653)
Basic net income (loss) per share	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)
Weighted average shares used in basic net income (loss) per share	33,490	30,510	32,650	30,050
Diluted net income (loss) per share	$ 0.01	$ (0.01)	$ 0.01	$ (0.09)
Weighted average shares used in diluted net income (loss) per share	36,022	30,510	35,193	30,050

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

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DIGITAL IMPACT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

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

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

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

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DIGITAL IMPACT, INC.

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

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

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

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DIGITAL IMPACT, INC.

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

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

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

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DIGITAL IMPACT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company

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

Digital Impact derives its revenues from the sale of solutions that enable businesses to proactively communicate with their customers online. Primarily, these services have consisted of the design and execution of online direct marketing campaigns, the development and execution of Customer Acquisition programs and additional services provided by the Professional Services organization.

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

Note 2. Summary of Significant Accounting Policies

Basis of presentation and liquidity

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

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

The accompanying interim condensed consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in Digital Impact s Annual Report on Form 10-K for the fiscal year ended March 31, 2003.

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

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

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

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

Use of estimates

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

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

Foreign currency translation

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

Revenue Recognition

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

Digital Impact applies the provisions of Staff Accounting Bulletin 104 Revenue Recognition and recognizes revenue when persuasive evidence of an arrangement exists, the service has been delivered, the fee is fixed or determinable and collection of the resulting receivables is reasonably assured. Customer Marketing revenues are recognized upon sending the campaigns. Revenues attributable to one-time set-up fees for service initiation are deferred and recognized ratably over the term of the client s service agreement, typically twelve months. Customer Acquisition revenues are derived primarily from programs that assist clients in growing their email lists through the use of third-party list rentals. Customer Acquisition programs fall into two general categories: List Rental programs and ProspectNet programs. List Rental programs involve the execution and delivery of email campaigns to a defined number of individuals provided by a third-party list rental or email address marketing service. ProspectNet programs involve the strategic placement of a Digital Impact client offer on a third-party site for the purpose of generating new opt-in email addresses for the client. Digital Impact contracts with third-party providers to deliver names of individuals who opt-in to join the client s email list. Digital Impact is obligated to make payments to third parties for the cost of services associated with the execution of List Rental and ProspectNet programs. Digital Impact accounts for revenues and costs associated with Customer Acquisition programs in accordance with Emerging Issues Task Force Issue No. 99-19 (EITF 99-19), Reporting Revenue Gross as a Principal versus Net as an Agent. The cost of Customer Acquisition campaigns are recognized in the period that the programs are executed and are netted against program revenue. The cost of Customer Acquisition campaigns are estimated using Company records of outstanding purchase commitments when final vendor invoices have not been received.

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

Digital Impact provides other complementary services to clients, such as strategy, solutions engineering, web-page development, creative design and data analytics. These services are typically billed on an hourly rate. The revenue for engagements that support the delivery of future products and services, such as targeted solutions, is deferred at the time of delivery and recognized pro-rata over the future periods of usage. The period over which the revenue is recognized varies, generally between one and twelve months, depending on the term of the contract or the estimated period of usage. Management uses their best estimates to determine the appropriate period for revenue deferral.

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

Cash, cash equivalents and short-term investments

The Company considers all highly liquid investments with an original or remaining maturity of three months or less at the time of purchase to be cash equivalents.

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

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

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

Concentration of credit risk and other risks and uncertainties

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

The Company s customers are primarily concentrated in the United States. The Company performs ongoing credit evaluations and establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of customers, historical trends and other information. For the nine months ended December 31, 2003, two customers represented 12% and 11% of revenue, respectively. For the nine months ended December 31, 2002, one customer represented 13% of revenue. As of December 31, 2003, one customer represented 10% of accounts receivable. As of December 31, 2002, one customer represented 11% of accounts receivable.

Research and development expense

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

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

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

Long-lived assets

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

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

Goodwill

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