Our People Make It Happen

Harte-Hanks, Inc. • 2001 Annual Report

Experienced.
Dedicated. Poised for the future.

OUR PEOPLE MAKE IT HAPPEN.

JAMES DAVIS   BILL CARMAN   FEDERICO ORTIZ   SPENCER JOYNER, JR.
BILL GOLDBERG   JESSICA HUFF   TANN TUELLER   KATHY CALTA   DEAN BLYTHE

These days, the business world is engaged in a tough round of "survival of the fittest." Obstacles and uncertainties surprise even the most seasoned players. In the end, it is not merely the strongest company that wins, but the one that remains focused, is directed with clarity and vision, and adapts to a demanding, changing environment.

Harte-Hanks is that company. As we navigate this difficult economic climate, Harte-Hanks is guided firmly by experienced leaders, a strong command of technology applications and the dedication of our people. We remain unwavering in our commitment to provide our clients with world-class, end-to-end customer relationship management (CRM), related direct and interactive marketing solutions, and targeted advertising vehicles.

Our full-service approach — CRM professional services to implementation to ongoing support; strong product and service brands including Allink™, Trillium™, *n*Touch and *PennySaver;* the use of targeted media from mail to Internet to Web to telephone; end-to-end execution from design and print to personalized mail and e-mail production; and shopper ads that are highly targeted by geography and all other cluster groupings that are driven by geography — continues to support our client-centric beliefs at all times.

We make it happen for our customers.

DIRECT MARKETING

Customer Relationship Management (CRM) and Marketing Services

Our **CRM** capabilities strengthen the relationships between our clients and their customers. We construct and update business-to-business and business-to-consumer databases. We access the data through flexible hosting capabilities and analyze information to help make it relevant. We apply the knowledge by putting data to work via multi-channel marketing programs, and we execute those programs through our **Marketing Services** delivery programs.

This is the Harte-Hanks definition of direct and interactive marketing services, which we customize to meet individual client needs. Our clients choose one or many of our offerings — and over time have the opportunity to add additional offerings as needed.

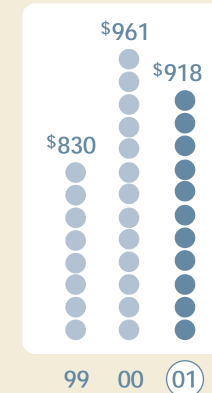
SHOPPER PUBLICATIONS

Each week, nearly 10 million households in California and South Florida receive Harte-Hanks **Shopper** publications. With more than 800 separate editions, these publications offer flexible zoning and virtually 100% market penetration in their areas of distribution. Also available in searchable, online editions, shopper publications provide a powerful local advertising system.

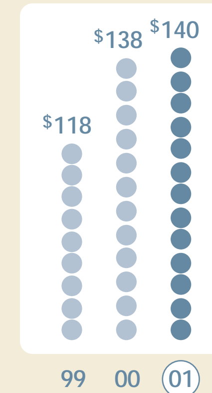
FINANCIAL HIGHLIGHTS

(in millions, except per share amounts)

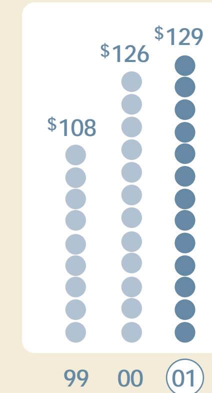
Operating Revenues



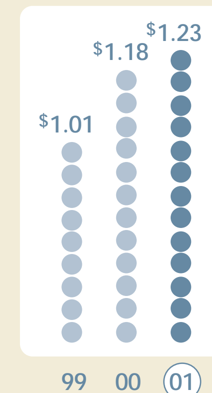
Operating Income



After-Tax Cash Flow



Earnings Per Share



Company Profile

A SOLID HISTORY. A BRIGHT FUTURE.

Based in San Antonio, TX, Harte-Hanks is a worldwide marketing company that provides end-to-end customer relationship management (CRM) and related solutions for businesses and organizations in both consumer and business-to-business markets across North America, Europe, South America and the Pacific Rim.

The people at Harte-Hanks make it happen for our clients. Our firm grasp of technology enables us to capture, analyze and disseminate customer and prospect data at all points of contact. Our services help clients generate traffic to Web sites, call/contact centers and retail locations while gaining knowledge about their customers in the process.

Our client roster includes many *Fortune* 1,000 companies, including industry leaders in retail, financial services, pharmaceuticals/healthcare, high-tech/telecommunications and automotive, among others.

In addition, Harte-Hanks owns and operates shopper publications that target households based on geography and other demographic criteria. Zoned into more than 800 editions, our shopper publications reach nearly 10 million households in California and South Florida each week.

FINANCIAL HIGHLIGHTS

(in thousands, except per share amounts)

	2001	2000	1999
Operating revenues	$917,928	$960,773	$829,752
Operating income	139,630	138,221	118,228
Depreciation	32,079	28,494	24,126
Goodwill and intangible amortization	16,841	15,226	10,662
Operating cash flow (operating income plus depreciation and goodwill and intangible amortization)	188,550	181,941	153,016
After-tax cash flow (net income plus depreciation and goodwill and intangible amortization)	128,604	125,606	107,729
Interest expense	3,076	1,678	349
Net income	79,684	81,886	72,941
Earnings per share (diluted)	1.23	1.18	1.01
Capital expenditures	26,445	36,465	28,928
Average common and common equivalent shares outstanding (diluted)	64,783	69,653	72,144

Even in this age of technology, nothing is more important than **PEOPLE MAKING IT HAPPEN.**

Understanding client needs and providing the right solutions

At Harte-Hanks, our solutions begin with a definitive understanding of our clients, the unique issues they face in their individual markets, and the challenges presented by their own financial realities.

Led by top talent in the direct marketing industry, our people work closely with clients to define specific needs and develop goals. By combining extensive knowledge of our clients' industries and a solid understanding of technology and its applications, we provide meaningful, measurable solutions.

Our leadership role in the CRM arena further helps us close the loop between our clients and their customers. Employing proven direct and interactive techniques helps us develop effective contact strategies based on purchase patterns, channel preferences and market environments.

Facing adversities, challenging ourselves — and winning

In 2001, we heard words like "economic uncertainty" and "recession." We witnessed unspeakable horror as America came under attack and prepared a defense unlike any before in our history. Throughout this difficult time, the people of Harte-Hanks have banded together as one company with a stronger understanding of the principles we hold dear. In this unpredictable economy, we continue our dedication to our clients, and we continue to hold ourselves accountable to our shareholders.

We believe healing and recovery are on the horizon. With strong people and a comforting range of competitive advantages, we are confident in our ability to overcome today's challenges. We are equally confident as we plan to face tomorrow's challenges with renewed purpose and enthusiasm.

GARY SKIDMORE
JACQUES KERREST
DONALD CREWS
CHARLES DALL'ACQUA
CRAIG COMBEST
PETER GORMAN

To Our Shareholders

To meet and to overcome challenges is why many clients turn to Harte-Hanks. Our people make solutions happen.

This year, the United States entered its first recession in a decade, ending its longest peacetime economic expansion. The uncertain times were exacerbated by September 11. We are thankful that no one at Harte-Hanks personally experienced a loss in their immediate families as a result of this terror. Some client companies were not so fortunate. Yet we were all deeply affected. "Getting back to normal" has been our nation's and our business's mantra.

In this difficult economy, the approximately 7,500 people of Harte-Hanks distinguished themselves by delivering extraordinary results. Throughout this report you see names and faces of some great people who "made it happen" in 2001. They are among many contributors, leaders and performers — too many to feature — who dedicate themselves to clients, shareholders and our culture. We thank them every bit as much as we do those who are shown in this Annual Report.

In 2001, diluted earnings per share were up 4.2% to $1.23 on a revenue decrease of 4.5% to $917.9 million. Direct Marketing experienced lower revenue from many clients, as they slowed their marketing and customer relationship management (CRM) investments — even as these investments are important to their future financial success. Direct Marketing revenue declined 9.1%, yet operating cash flow was down only 0.9%. This was the first year in 11 that Direct Marketing experienced a decline in either revenue or operating cash flow. Shoppers had outstanding financial performance: revenue up 5.8% and operating cash flow up 11.6%.

Going into 2001, our Direct Marketing business in retail had slowed significantly and the high technology sector started an even steeper slump. We worked on how to deal with revenue declines, and to balance the cost structure with the reality of '01 revenues. We focused on cost control. We achieved success.

With cost issues still top-of-mind, we further highlighted revenue growth. Our focus is on the basics, making the most of our competitive advantages: financial health; deep experience in what we do and the markets we serve; high-performance proprietary software and applications, as well as partnerships with best-of-breed companies; and a "make it happen" attitude that permeates our delivery.

In Direct Marketing, we have taken advantage of synergies within our company, and rolled out several new products and services to capitalize on our clients' needs for data quality, data management, data analysis, information application, and direct and interactive marketing services execution.

Helped by these new products and services — Trillium Software System® Version 5.0, with Customer Key Manager; Allink™ Connect; Allink Xpert; Allink Customer Data Management; Allink Retail Daily Sales Builder; Allink Daily Deposit Builder; Harte-Hanks M/CIS; and CI Technology Database for CRM and for E-Business — both Harte-Hanks and its Trillium Software division were named to the *DM Review* 100 as leading "business intelligence vendors for CRM." This double citation is a first-time achievement for our company.

Our CRM business in Europe was also streamlined to facilitate client capabilities. A Latin American version of our CI Technology Database was launched. International business now accounts for 4% of total revenues.

Our Shoppers also kept a watchful eye on cost control, while successfully delivering outstanding revenue growth for the third year in a row. We completed the rollout of process four-color printing capability to our entire shopper publications' circulation of nearly 10 million. To capitalize on the strong brand name "PennySaver," as well as to enhance services to businesses wanting to get their advertising message out later in the week, a second edition of *PennySaver* was started, reaching a circulation of 250,000 in Orange County, CA.

During 2001, we repurchased 3.6 million shares of our own stock under the repurchase program first authorized in January 1997. Since inception we have repurchased 17.7 million shares, and have 4.9 million shares remaining under authorization at the end of 2001.

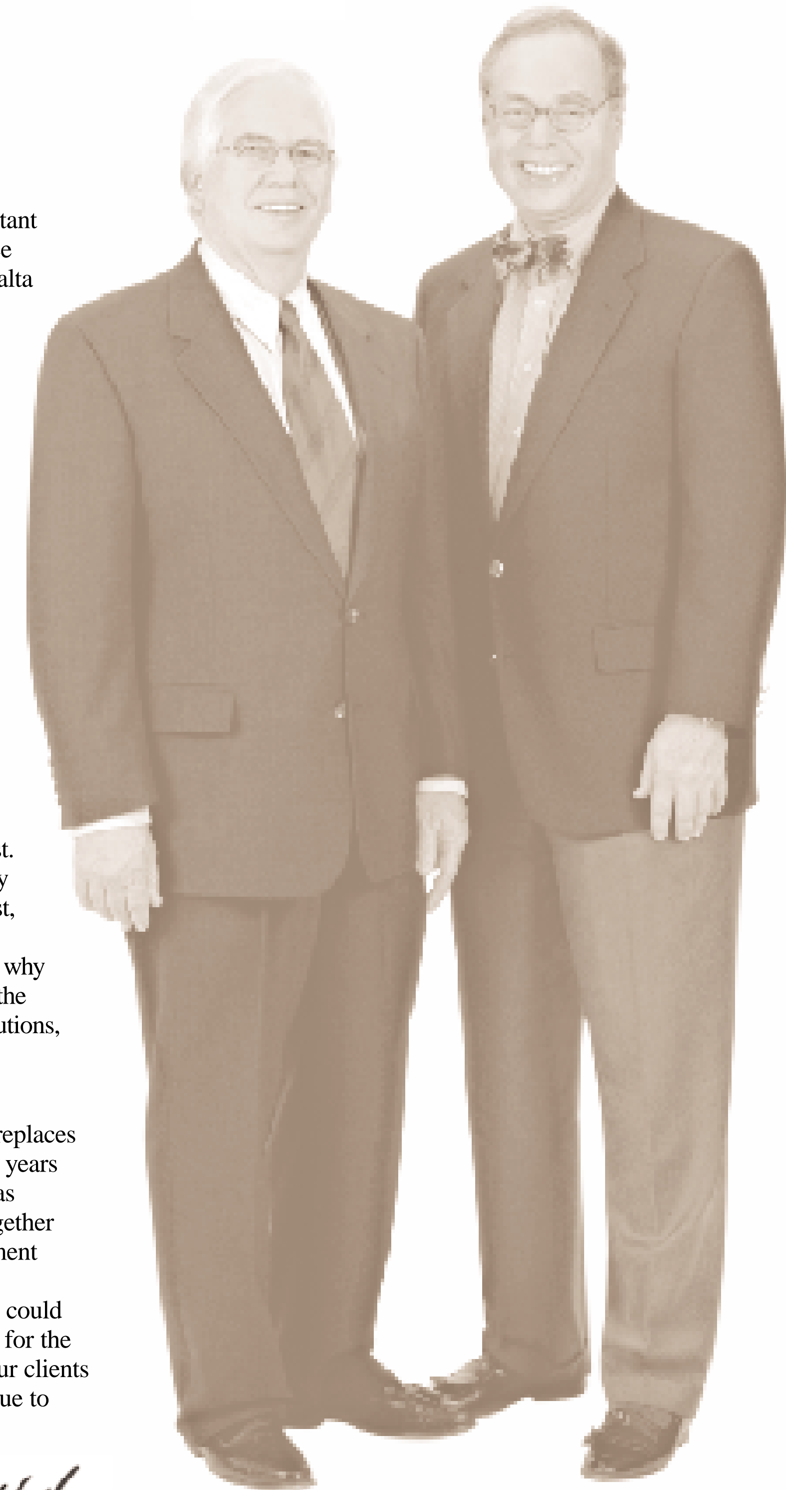
In November 2001, we acquired Sales Support Services, Inc, a leading business-to-business lead generation, order processing and fulfillment services company with a history of long-lasting client relationships in energy, automotive and other industries. We believe this company will provide an excellent complement to our CRM Services offerings and help us capitalize on opportunities in these strategic markets.

Harte-Hanks continues to invest in its people, as the caliber of our professional expertise is our most important competitive advantage. During the year, we filled three key positions through internal promotions — Kathy Calta to group president, CRM Database; Bill Goldberg to president, national sales and strategic markets; and Dave LaGreca to chief information officer, Direct Marketing. Additionally, Dean Blythe was named vice president, legal and secretary, replacing Don Crews who retired at the beginning of 2002 after a long and distinguished career at Harte-Hanks.

In November, William K. Gayden was elected to our Board of Directors. Bill is chairman and chief executive officer of Merit Energy Company in Dallas, TX. Before forming Merit Energy in 1989, he was president of Petrus Oil Company, and previously held various positions with Electronic Data Systems Corporation. Bill's capabilities will be valuable to our company.

Looking ahead. The difficult economic climate continues in 2002. Our people remain committed to delivering excellent performance as they have in the past. As you see throughout this report, Harte-Hanks is a very sound company. We have the financial strength to invest, regardless of the economic climate, in people, systems, solutions, capital expenditures and acquisitions. That is why we are confident we will deliver on our vision: "To be the provider of premier direct and interactive marketing solutions, and to provide outstanding returns to all stakeholders."

On April 1, 2002, we begin the next evolution of our management team as one of us, Richard Hochhauser, replaces the other, Larry Franklin, as CEO. With more than 30 years with the company, Larry will continue to be involved as chairman of the board. The two of us have worked together for years, along with our very capable senior management team. All have been deeply involved in key corporate decisions that have made Harte-Hanks successful. We could not be more excited and confident about the prospects for the company. All our people take our responsibilities to our clients and to our shareholders very seriously. We will continue to make it happen for all of you.

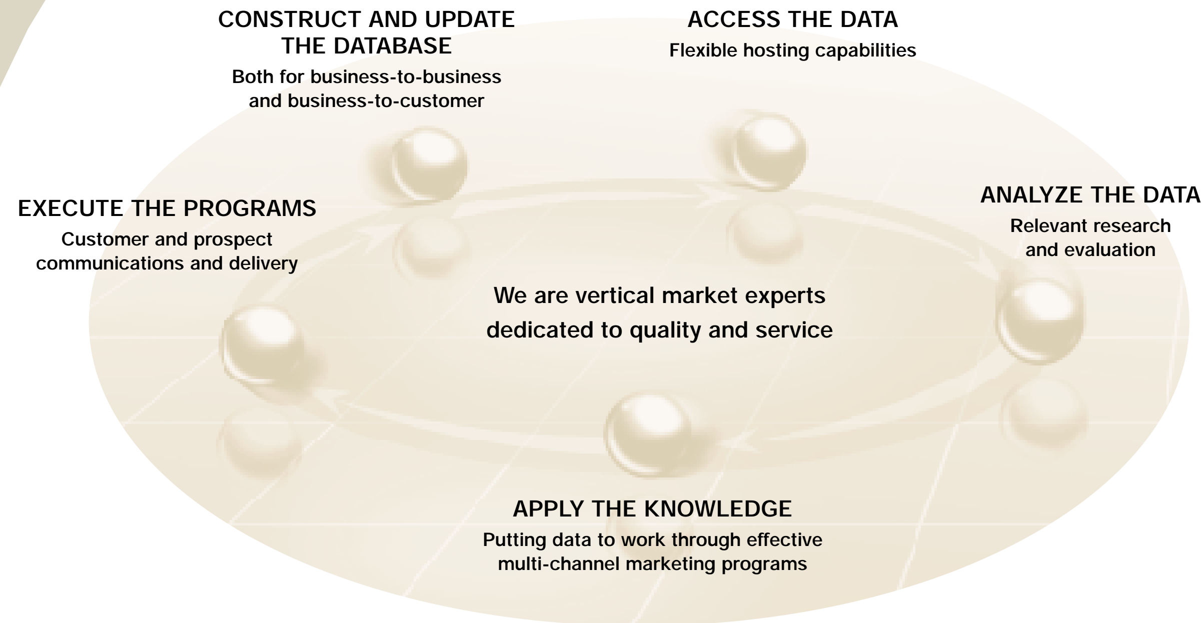


LARRY FRANKLIN
Chairman and
Chief Executive Officer

RICHARD HOCHHAUSER
President and
Chief Operating Officer

Direct Marketing

HOW OUR PEOPLE MAKE IT HAPPEN...



Construct and update the database

Harte-Hanks offers a wide array of database construction tools and services, including design, consulting, construction and management. Our professional services teams use these industry-leading tools, such as **Relationship Builder**, to provide systems integration and support to clients in a variety of industries. Because Harte-Hanks has been executing these processes for more than 20 years, they are "production proofed."

Harte-Hanks offers a full range of business-to-business and business-to-consumer service bureau processing, including data capture and the preparation of data feeds, marketing lists and files.

Trillium™, our proprietary software, remains the industry's leading global data quality tool for cleansing, standardization and relationship matching solutions. It is designed to cleanse all types of data in both legacy and operational online environments for CRM, e-business and data warehouse applications.

Our leadership in database solutions enabled Harte-Hanks to partner successfully with important new clients in 2001, including some of the most recognizable names in the financial, pharmaceutical, retail, automotive and high-tech industries.

SEDRICK PERRY · TERRY OLSON · JOHN NICOLI · JOEL BAKAL · BELINDA CASPER · ANDREW RUTBERG · CAROLYN DELUCA · CAROLYN SCHRADER

Access the data

The Harte-Hanks **Allink**™ **Suite** provides a continually growing portfolio of data access tools, such as **Allink**™ **Transact**, **Xpert** and **Connect**, that can stand alone or work in an integrated fashion to give clients fast and accurate access to customer information, campaign management and analytics.

Our **Allink**™ **Agent** software and marketing solutions, such as **Retail Daily Sales Builder**, are real-time CRM database systems that blend customer transaction data and professional and marketing services with the sophistication of real-time personalization.

Used heavily in the retail and financial services industries, **P/CIS**™ is our industry-leading data access tool that ensures fast data access using a simple GUI. Using **Desktop Direct**, clients can track promotional history and measure results on their P/CIS database. The new multi-channel version, **M/CIS**, was released at the end of the year.

Analyze the data

Our team of analysis and research professionals provides clients with a clear understanding of their customers and their markets, turning data into actionable information. Customized services include market research, Web site analysis, database analysis and modeling, and direct marketing response analysis.

NATACHA HOSY · PAUL KAMMANN · MATTHEW POLLOCK · BRAD WAMSLEY · DEBORAH SULLIVAN · RANDY WUSSLER · WENDY TABENSKE · SYDNEY HOFFMAN · MARIE DONA PEELER

LARRY HAWKS
KEVIN KERNER
DON AICKLEN
JIM CORRELL
GREGG HARPER

Direct Marketing

Apply the knowledge

Harte-Hanks has more than 30 years' experience managing intricate direct marketing programs, including campaign planning and management, customer acquisition programs, loyalty programs, customer retention programs, privacy initiatives, merger and acquisition communications, strategic planning, customer care and customized solutions.

Full-service direct marketing agency services combine information-based strategy and brand-building creative to develop and deliver promotional pieces. Expert media planning and management ensure that the most appropriate and most cost-effective media channels are utilized.

The ***n*****Touch** suite of CRM tools enables customers to provide highly personalized e-marketing campaigns, Web-based lead management and multi-channel customer care.

LUCY ORME-SMITH JO VAN SAMANG MIKE SMITH JILL LINSENBERG DAN RUBIN LI SAUL THOMAS COLLINS

LIN WELLS

KEVIN CULVER BRUNO CATRAMBONE

PETER DETREMPE JENNIFER BOHANNON HEATHER COSTELLO EVETE COPELAND DAVID LAGRECA JULIE DONOVAN ANDREW HARRISON

SHARRON AMES JERRY FERGUSON

JAN HOGAN

STEVEN GRAY ERWIN VANSPAUWEN

KYLE KENNEDY

KEN LAMBERT CRAIG MEURER

Execute the programs

Harte-Hanks is well-equipped to execute the most complex direct marketing programs, whether traditional or Web-based, helping clients reach customers with the right message, via the right media channel, at the right time.

One of the largest non-government solo mailers in the United States, Harte-Hanks offers services that range from state-of-the-art printing and laser personalization to logistics and mail delivery confirmation. Fulfillment services include print-on-demand, Web-based inventory management and ordering tools, and e-fulfillment, as well as more traditional functions. Our worldwide network supports these capabilities, giving Harte-Hanks a true competitive advantage.

We initiate and receive outbound and inbound telemarketing calls on behalf of clients to provide lead generation, telesales, customer care and technical support. We also provide customized sales lead management solutions.

In addition, Harte-Hanks interactive solutions provide the ultimate in one-to-one targeting, unparalleled reach and sound ROI. Webinars, Web site design and management, computer-based education and online direct marketing program management complement and extend traditional avenues of customer contact.

MICHAEL FITZGERALD WAYNE ROSENBERGER SUSAN WARD FRANK HARVEY MICHELE FITZPATRICK JIM NEUMANN KEVIN SWEENEY JOHN DENNISON KAREN RAVAS

NORMAN SALLITT MIKE WATSON BILLIE GRAY KIM SMITH ROBERT MASON BETTIE HENDRICKX RICK KEGLEY ROBERT COLUCCI

Shopper Publications

Winning in a tough economy

Harte-Hanks shopper publications continue to provide an effective, cost-efficient advertising channel in California and South Florida. Led by a strong management team, our shoppers experienced healthy growth in both in-book and distribution product sales in 2001, despite a slower economy.

Zoned into more than 800 separate editions, the shoppers reach nearly 10 million households. More than 2,000 combinations of geographic and demographic coverage provide flexibility in targeting and messaging, allowing advertisers to focus on a particular neighborhood or demographic group within a specific area.

In California, ***PennySaver*** reaches more than 70% of the households in the state, while more than a million households in South Florida receive ***The Flyer***. Mailed weekly, these publications are free of charge to readers.

Advertisers can choose a full range of options including pre-printed inserts, print and deliver flyers, detached cards, rack products, VIP cards and MARQUEE™, as well as traditional classified, display and in-column ads and Web-based products.

ROY FAIRBANKS

KENNETH DURRUM

ORESTES BAEZ

DEBRA WATSON

LISA DEL MONTE

ORLANDO BARO

TIM RYCHEL

JAMI DELPERDANG

JACK COLOPY
MIKE PAULSIN
GAYLE PITTS
LOREN DALTON
BOB FALK
STEPHEN CARAZO
CARLOS GUZMAN

Financial Contents

Managing today's challenges, exploring tomorrow's opportunities

Throughout our history, our successes can be traced to strong leadership across the Harte-Hanks organization. Given the current economic challenges, strong leaders — those who provide guidance, motivation and direction — are more valuable than ever. The breadth and depth of experience the Harte-Hanks team brings to the table is rare. It is what will see us through difficult times and guide us toward a bright future.

As a result, every Harte-Hanks employee shares common bonds: we understand clients and their marketplace challenges, we embrace technology, and we commit to winning.

Now more than ever, our people make it happen.

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DAVE CLARK
TIMOTHY SHERMAN
PAUL GAGLIARDI
ELAINE BUCKLEY
RICK CLUFF
GREG SNYDER
HOWARD YOUNG

Overview

Management's Discussion and Analysis of Financial Condition and Results of Operations

The Company's overall performance reflects its commitment to its strategy of remaining a market leader in the targeted media industry, introducing new products and entering new markets, investing in technology and people, and increasing shareholder value. Harte-Hanks is an international direct and interactive marketing services company that provides end-to-end customer relationship management (CRM), related marketing services and shopper publications to a wide range of industries serving both consumer and business-to-business markets. The Company's solutions use technology as the enabler to capture, analyze and disseminate customer and prospect data at all points of contact. The Harte-Hanks customer-centric models allow it to be the overall solutions provider for driving traffic to brick-and-mortar locations, Web sites or call/contact centers. A full-service approach — CRM professional services to implementation to ongoing support; strong product and service brands including Allink™, Trillium™, *n*Touch and PennySaver; the use of targeted media from mail to Internet to Web to telephone; end-to-end execution from design and print to personalized mail and e-mail production; and shopper ads that are highly targeted by geography and other cluster groupings that are driven by geography — supports Harte-Hanks customer-centric beliefs. As of December 31, 2001, the Company's highly targeted advertising shopper publications covered 800 geographic zones and reached nearly 10 million households each week.

Harte-Hanks has grown internally by adding new customers and products, cross-selling existing products, entering new markets and expanding its international presence. The Company also used proceeds from the sales of its newspaper and television operations, borrowings against its credit facilities and its excess cash flows to fund several acquisitions in 1999, 2000 and 2001. These acquisitions, as well as several previous acquisitions, have enhanced the Company's growth over the past three years. Harte-Hanks has funded $209.6 million in acquisitions during the period 1999 through 2001. These acquisitions have all been in the Company's direct and interactive marketing segment, which now comprises approximately 66% of the Company's revenues.

Harte-Hanks derives its revenues from the sale of direct and interactive marketing and advertising services. As a worldwide business, direct and interactive marketing is affected by general national and international economic trends. Shoppers operate in local markets and are affected by the strength of the local economies. The Company's principal expense items are payroll, postage, transportation and paper.

Results of Operations

Operating results were as follows:

In thousands	2001	% Change	2000	% Change	1999
Revenues	$ 917,928	-4.5	$ 960,773	15.8	$ 829,752
Operating expenses	778,298	-5.4	822,552	15.6	711,524
Operating income	$ 139,630	1.0	$ 138,221	16.9	$ 118,228

Consolidated revenues declined 4.5% to $917.9 million while operating income grew 1.0% to $139.6 million in 2001 compared to 2000. Overall operating expenses decreased 5.4% to $778.3 million. The Company's overall results reflect revenue and operating income declines in its direct and interactive marketing segment, partially offset by increased revenue and operating income in the shopper segment.

Overall growth in 2000 revenues and operating income resulted from acquisitions, increased business from both new and existing customers and from the sale of new products and services. Overall operating expenses increased as a result of the overall revenue growth, including the acquisitions, and the hiring of additional personnel to support the growth.

Direct Marketing

Direct marketing operating results were as follows:

In thousands	2001	% Change	2000	% Change	1999
Revenues	$ 601,901	-9.1	$ 662,044	18.4	$ 559,262
Operating expenses	516,881	-9.4	570,594	18.8	480,098
Operating income	$ 85,020	-7.0	$ 91,450	15.5	$ 79,164

Direct and interactive marketing revenues decreased $60.1 million, or 9.1%, in 2001 compared to 2000. These results reflect declines in almost all of direct and interactive marketing's vertical markets, including declines in the segment's largest vertical markets, retail, financial services and high-tech/telcom. The overall decline was partially offset by strong growth in revenues from the pharmaceutical and healthcare industries. Both Customer Relationship Management (CRM) and Marketing Services revenues declined from the prior year. CRM experienced revenue declines in data processing, agency, consulting, fulfillment, telesales and brokered customer list business, partially offset by increased software revenue and revenue attributable to 2001 and 2000 acquisitions. Marketing Services experienced revenue declines in its personalized direct mail, targeted mail and logistics operations.

Operating expenses decreased $53.7 million, or 9.4%, in 2001 compared to 2000. The overall decrease in operating expenses was primarily due to the Company's efforts to manage its cost structure during the current economic environment, as well as reduced variable expenses resulting from lower revenue levels. Production and distribution costs decreased $28.4 million due primarily to decreased volumes and better pricing obtained from vendors. Labor costs declined $16.2 million due to lower volumes and staff reductions. General and administrative expense decreased $14.4 million due to employee and professional services expenses. Depreciation expense increased $3.7 million due to new capital investments to support future growth and improve efficiencies. Goodwill and intangible amortization expense increased $1.6 million due to prior year acquisitions. Operating expenses were also impacted by 2001 and 2000 acquisitions.

Direct and interactive marketing revenues increased $102.8 million, or 18.4%, in 2000 compared to 1999. CRM experienced significant revenue growth in 2000 due to increased data processing, Internet and fulfillment business with both new and existing customers. Also contributing to the CRM revenue growth was the October 1999 acquisition of ZD Market Intelligence, renamed Harte-Hanks Market Intelligence, and to a much lesser extent the November 2000 acquisition of Information Resource Group and the June 2000 acquisition of Hi-Tech Marketing Limited. The traditional growth oriented business-to-business activities of CRM had significant growth. The high-tech, mutual fund, non-bank finance, telecommunications and healthcare industry sectors contributed significantly to overall CRM revenue growth, offsetting slowdowns in the insurance industry. Marketing Services also experienced good revenue growth in 2000, led by its targeted mail operations. Marketing Services revenues increased due to increased product sales to both new and existing customers, primarily in the non-bank finance, banking and pharmaceutical industry sectors, offsetting slowdowns in the retail industry. The May 1999 acquisition of Direct Marketing Associates, Inc. also contributed to the Marketing Services revenue growth. Overall, revenue growth for direct and interactive marketing increased as a result of increased business with both new and existing customers across several industry sectors including high-tech, non-bank finance, mutual fund, healthcare, banking, telecommunications and pharmaceutical, as well as the acquisitions noted above.

Operating expenses rose $90.5 million, or 18.8%, in 2000 compared to 1999 due primarily to revenue growth contributed by acquisitions, which accounted for approximately 58% of this

increase. Excluding these acquisitions, operating expenses increased 8.3%. This remaining increase was due to increased production costs directly associated with increased product volumes, increased payroll costs due to expanded hiring to support revenue growth and increased general and administrative expense from professional and business service fees and employee expenses. Depreciation and amortization expense increased $8.8 million due to goodwill associated with acquisitions and higher levels of capital investment to support growth.

Shoppers

Shopper operating results were as follows:

In thousands	2001	% Change	2000	% Change	1999
Revenues	$ 316,027	5.8	$ 298,729	10.4	$ 270,490
Operating expenses	252,629	4.0	243,019	8.7	223,475
Operating income	$ 63,398	13.8	$ 55,710	18.5	$ 47,015

Shopper revenues increased $17.3 million, or 5.8%, in 2001 when compared to 2000. Revenue increases were the result of improved sales in established markets as well as geographic expansions into new neighborhoods in both California and Florida. On a product basis, revenues increased due to growth in distribution products and in-book products, primarily core sales and real estate related advertising. These increases were partially offset by declines in employment advertising, print-and-deliver and coupon book revenues.

Shopper operating expenses rose $9.6 million, or 4.0%, in 2001 compared to 2000. The increase in operating expenses was primarily due to increases in production costs of $5.6 million, including increased postage of $3.5 million due to higher postage rates and increased circulation and volumes. Promotion costs also increased $2.9 million, labor costs increased $2.0 million, and insurance costs were up $1.0 million.

Shopper revenues increased $28.2 million, or 10.4%, in 2000 when compared to 1999. Revenue increases were the result of improved sales in established markets as well as geographic expansions into new neighborhoods in both California and Florida. On a product basis, revenues increased due to growth in in-book products, primarily employment and automotive related advertising and core sales, and distribution products, primarily pre-printed inserts and four-color glossy flyers. Shoppers also experienced growth from up-selling ads onto its Web site.

Shopper operating expenses rose $19.5 million, or 8.7%, in 2000 compared to 1999. The increase in operating expenses was primarily due to increases in labor costs of $6.5 million and additional production costs of $8.8 million, including increased postage of $5.3 million due to increased circulation and insert volume growth.

Acquisitions

As described in Note B of the "Notes to Consolidated Financial Statements" included herein, the Company made several acquisitions in the past three years.

In November 2001, the Company acquired Sales Support Services, Inc. (SSS), a leading business-to-business lead generation, order processing and fulfillment services company to the automotive, energy and other industries.

The Company acquired Detroit-based Information Resource Group, a leading provider of business-to-business intelligence solutions to the high-tech, telecommunications and other industries, in November 2000, and Hi-Tech Marketing Limited (HTM), a London based leading pan-European provider of CRM services to the hightech, telecommunications and financial services industries, in June 2000.

In October 1999, the Company acquired ZD Market Intelligence, renamed Harte-Hanks Market Intelligence, for $101 million in cash from Ziff-Davis, Inc. Harte-Hanks Market Intelligence is a leading provider of database products and solutions to the high-tech and telecommunications industries in the United States, Canada and Europe.

The Company acquired Direct Marketing Associates, Inc. of Baltimore, Maryland, a leading provider of integrated direct marketing services to commercial, government and non-profit organizations, in May 1999, and LYNQS Newmedia of Kansas City, Missouri, a developer of new media applications for the financial services, pharmaceutical and other industries, in June 1999.

Interest Expense/Interest Income

Interest expense increased $1.4 million in 2001 over 2000 due primarily to higher outstanding debt levels during 2001 of the Company's three-year revolving credit facility, the proceeds of which were used to repurchase the Company's stock and fund the November 2001 acquisition of SSS. Interest relating to the Company's unsecured credit facility obtained for the purpose of constructing a new building in Belgium, and a note payable issued in connection with the Company's June 2000 acquisition of HTM, also contributed to the increase in interest expense during the year. The increase in interest expense in 2001 was partially offset by lower interest rates in 2001 compared to 2000. Total interest expense increased in 2000 when compared to 1999 primarily due to interest, commitment charges and the amortization of financing costs from the two unsecured revolving credit facilities. Interest related to the Company's unsecured credit facility obtained for the purpose of constructing a new building in Belgium, and the note payable issued in connection with the June 2000 acquisition of HTM, also contributed to the increase in interest expense. The Company's debt at December 31, 2001 and 2000 is described in Note D of the "Notes to Consolidated Financial Statements," included herein.

Interest income decreased $1.6 million in 2001 over 2000 due to lower interest rates and lower overall cash balances during the year. Interest income decreased $3.6 million in 2000 over 1999 due to the sale of all of the Company's short-term investments during 1999, the proceeds of which were used to fund acquisitions and repurchase the Company's stock, and lower overall cash balances during the year.

Other Income and Expense

During 2001 the Company realized $2.5 million in losses on the sales of investments that were classified as available for sale and $.9 million on the sales of investments that were accounted for under the cost method.

Income Taxes

Income taxes decreased $2.2 million in 2001 due to lower income levels. Income taxes increased $5.1 million in 2000 due to higher income levels. The effective income tax rate was 39.8%, 40.2%, and 40.6% in 2001, 2000 and 1999, respectively. The effective income tax rate calculated is higher than the federal statutory rate of 35% due to the addition of state taxes and certain expenses recorded for financial reporting purposes (primarily goodwill amortization) that are not deductible for federal income tax purposes.

Capital Investments

Net cash used in investing activities for 2001 included $28.2 million for acquisitions and $26.4 million for capital expenditures. The acquisition investments, which were made in the direct and interactive marketing segment, are discussed under "Acquisitions." The capital expenditures consisted primarily of additional computer capacity, technology, systems, new press equipment and equipment upgrades for the direct and interactive marketing segment to support its growth in all sectors. The Company also invested in facility expansion in its CRM sector. The shopper segment's capital expenditures were primarily related to facility improvements and additional computer and other production equipment.

Net cash used in investing activities for 2000 included $43.9 million for acquisitions and $36.5 million for capital expenditures. The acquisition investments, which were made in the direct and interactive marketing segment, are discussed under "Acquisitions." The capital expenditures consisted primarily of the construction of a new building to expand and support the Company's CRM operations in Belgium, additional computer capacity, technology, systems and equipment upgrades for the direct and interactive marketing segment to support its growth in all sectors. The Company also invested in facility expansions in its CRM and Marketing Services sectors. The shopper segment's capital expenditures were primarily related to new press, computer and other production equipment.

Critical Accounting Policies

Financial Reporting Release No. 60, which was recently released by the Securities and Exchange Commission, requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note A of the "Notes to Consolidated Financial Statements," includes a summary of the significant accounting policies and methods used in the preparation of the Company's Consolidated Financial Statements. The following is a discussion of the more significant accounting policies and methods.

Revenue Recognition — The Company recognizes revenue at the time the service is rendered or the product is delivered. Payments received in advance of the performance of services or delivery of the product are recorded as deferred revenue until such time as the services are performed or the product is delivered.

As described below, significant management judgments and estimates must sometimes be made and used in connection with the revenue recognized in any accounting period.

For all sales the Company requires either a purchase order, a statement of work signed by the customer, a written contract, or some other form of written authorization from the customer.

Direct and interactive marketing revenue is derived from a variety of CRM and marketing services solutions. Revenue from marketing services such as creative and graphics, printing, personalization of communication pieces using laser and inkjet printing, target mail, fulfillment, agency services and transportation logistics are recognized as the work is performed. Revenue is typically based on a set price or rate given to the customer.

CRM revenue from the ongoing production and delivery of data is recognized upon completion and delivery of the work and is typically based on a set price or rate. Revenue from time-based subscriptions is based on a set price and is recognized ratably over the term of the subscription.

Revenue from database build services may be billed based on hourly rates or at a set price. If billed at a set price, the database build revenue is recognized over the contractual period, using the percentage-of-completion method based on individual costs incurred to date compared with total estimated contract costs.

Revenue from market research and analytical services may be billed based on hourly rates or a set price. If billed at a set price, the revenue is recognized over the contractual period, using the percentage-of-completion method based on individual costs incurred to date compared with total estimated contract costs. In other instances, progress toward completion is based on performance milestones specified in the contract where such milestones fairly reflect progress toward contract completion.

Revenue related to e-marketing, lead management, multi-channel customer care, inbound and outbound teleservices and technical support is typically billed based on a set price per transaction or service provided. Revenue from these services is recognized as the service or activity is performed.

Revenue from software is recognized in accordance with the American Institute of Certified Public Accountants' (AICPA) Statement of Position ("SOP") 97-2 "Software Revenue Recognition," as amended by SOP 98-9 "Modification of SOP 97-2, Software Revenue Recognition." SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the vendor-specific objective evidence of fair values of the respective elements. For software sales with multiple elements (for example, undelivered postcontract customer support or "PCS"), the Company allocates revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements. This means the Company defers revenue from the software sale equivalent to the fair value of the undelivered elements. The fair value of PCS is based upon separate sales of renewals to other customers or upon renewal rates quoted in the contracts. The fair value of services, such as training and consulting, is based upon separate sales of these services to other customers.

The revenue allocated to PCS is recognized ratably over the term of the support period. Revenue allocated to professional services is recognized as the services are performed. The revenue allocated to software products, including time-based software licenses, is recognized, if collection is probable, upon execution of a licensing agreement and shipment of the software or ratably over the term of the license, depending on the structure and terms of the arrangement. If the licensing agreement is for a term of one year or less and includes PCS, the company recognizes the software and the PCS revenue ratably over the term of the license.

The Company applies the provisions of Emerging Issues Task Force Issue No. 00-03 "Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware" to its hosted software service transactions. Revenue under hosted service transactions is typically recognized over the service period unless the customer is able to take possession of the software during the service period. In such situations, revenue is recognized pursuant to SOP 97-2, as described above.

Shopper services are considered rendered, and the revenue recognized, when all printing, sorting, labeling and ancillary services have been provided and the mailing material has been received by the United States Postal Service.

***Allowance for Doubtful Accounts* —** The Company maintains its allowance for doubtful accounts at a balance adequate to reduce accounts receivable to the amount of cash expected to be realized upon collection. The methodology used to determine the minimum allowance balance is based on the Company's prior collection experience and is generally related to the accounts receivable balance in various aging categories. The balance is also influenced by specific customers' financial strength and circumstance. Accounts that are determined to be uncollectible are written off in the period in which they are determined to be uncollectible. Periodic changes to the allowance balance are recorded as increases or decreases to bad debt expense, which is included in the "Advertising, selling, general and administrative" line of the Company's Consolidated Statements of Operations. The Company recorded bad debt expense of $4.4 million, $4.6 million, and $1.8 million for the years ended December 31, 2001, 2000 and 1999, respectively.

***Reserve for Workers Compensation, Automobile and General Liability* —** The Company has a $250,000 deductible for worker's compensation, automobile and general liability. The estimate of loss reserves necessary for claims is based on the Company's estimate of claims incurred as of the end of the year. The Company uses detail loss-run claim reports provided by the insurance administrator and applies actuarial development factors to the claim loss balance to determine an appropriate reserve balance. The loss-run claim reports show all claims and an estimate of what the claim will cost. This estimate is provided by the insurance administrator based upon their experience dealing with similar type claims. The Company uses the loss-run claim reports as a basis for its reserve balance. Periodic changes to the reserve are recorded as increases or decreases to insurance expense, which is included in the "Advertising, selling, general and administrative" line of the Company's Consolidated Statement of Operations.

***Goodwill* —** Goodwill is recorded in purchase business combinations as the excess of the purchase price over the fair value of assets acquired and liabilities assumed. Recorded goodwill is amortized on a straight-line basis over periods of 15 to 40 years. The Company assesses the recoverability of its goodwill by determining whether the recorded goodwill balance can be recovered through projected undiscounted future cash flows over the remaining amortization period. If projected undiscounted future cash flows indicate that unamortized goodwill will not be recovered, an impairment loss is recognized based on projected discounted future cash flows. Cash flow projections are based on trends of historical performance and management's estimate of future performance, giving consideration to existing and anticipated competitive and economic conditions. This assessment is typically done on an annual basis, but can be done more frequently whenever events or changes in circumstances indicate that the unamortized goodwill balance may not be recoverable. The Company has not recorded an impairment loss in any of the three years ended December 31, 2001.

The Company will adopt Statement of Financial Account Standards ("SFAS") No. 142 on January 1, 2002, except that goodwill associated with the November acquisition of SSS was not amortized during 2001 in accordance with SFAS No. 141, "Business Combinations." SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. As a result of the adoption of SFAS No. 142, the Company will cease to amortize $434.4 million of goodwill. The company recorded $16.2 million, $14.8 million and $10.6 million of goodwill amortization expense for the years ended December 31, 2001, 2000 and 1999. In lieu of amortization, the Company is required to perform an initial impairment assessment of its goodwill in 2002 and an annual impairment assessment thereafter. SFAS No. 142 is described in more detail in Note A of the "Notes to Consolidated Financial Statements," included herein.

Liquidity and Capital Resources

Cash provided by operating activities for 2001 was $152.9 million. Net cash outflows from investing activities were $53.4 million for 2001, resulting primarily from the acquisitions and capital investments described above. Net cash outflows from financing activities in 2001 were $92.0 million. The cash outflow from financing activities is attributable primarily to the repurchase of stock throughout 2001 totaling $83.7 million. The acquisitions and repurchases of stock in 2001 were funded through the Company's cash flows and borrowings under the Company's credit facilities.

Cash provided by operating activities for 2000 was $110.9 million. Net cash outflows from investing activities were $79.5 million for 2000, resulting primarily from the acquisitions and capital investments described above. Net cash outflows from financing activities in 2000 were $43.7 million. The cash outflow from financing activities is attributable primarily to the repurchase of stock throughout 2000 totaling $92.7 million. The acquisitions and repurchases of stock in 2000 were funded through the Company's cash flows and borrowings under the Company's credit facilities.

Capital resources are available from, and provided through, the Company's two unsecured credit facilities. These credit facilities, two $100 million variable rate, revolving loan commitments, were put in place on November 4, 1999. All borrowings under the $100 million revolving Three-Year Credit Agreement are to be repaid by November 4, 2002. On October 26, 2001 the Company was granted a 364-day extension to its $100 million revolving 364-Day Credit Agreement. All borrowings under the $100 million revolving 364-Day Credit Agreement are to be repaid by October 25, 2002. The Company has classified its debt at December 31, 2001 as long-term as it is the Company's intent to refinance all outstanding balances under these credit facilities at the time they expire. The Company believes it will be able to obtain additional credit facilities at comparable amounts and terms based on the Company's financial position and relationships with its existing lenders.

Management believes that its credit facilities, together with cash provided by operating activities, will be sufficient to fund operations and anticipated acquisitions and capital expenditures needs for the foreseeable future. As of December 31, 2001, the Company had $155.0 million of unused borrowing capacity under its credit facilities.

Factors That May Affect Future Results and Financial Condition

From time to time, in both written reports and oral statements by senior management, the Company may express its expectations regarding its future performance. These "forward-looking statements" are inherently uncertain, and investors should realize that events could turn out to be other than what senior management expected. Set forth below are some key factors that could affect the Company's future performance, including its revenues, net income and earnings per share; the risks described below, however, are not the only ones the Company faces. Additional risks and uncertainties that are not presently known, or that the Company currently considers immaterial, could also impair the Company's business operations.

***Legislation* —** There could be a material adverse impact on the Company's direct and interactive marketing business due to the enactment of legislation or industry regulations arising from public concern over consumer privacy issues. Restrictions or prohibitions could be placed upon the collection and use of information that is currently legally available.

***Data Suppliers* —** There could be a material adverse impact on the Company's direct and interactive marketing business if owners of the data the Company uses were to withdraw the data. Data providers could withdraw their data if there is a competitive reason to do so or if legislation is passed restricting the use of the data.

***Acquisitions* —** In recent years the Company has made a number of acquisitions in its direct and interactive marketing segment, and it expects to pursue additional acquisition opportunities. Acquisition activities, even if not consummated, require substantial amounts of management time and can distract from normal operations. In addition, there can be no assurance that the synergies and other objectives sought in acquisitions will be achieved.

***Competition* —** Direct and interactive marketing is a rapidly evolving business, subject to periodic technological advancements, high turnover of customer personnel who make buying decisions, and changing customer needs and preferences. Consequently, the Company's direct and interactive marketing business faces competition in both of its sectors — CRM and Marketing Services. The Company's shopper business competes for advertising, as well as for readers, with other print and electronic media. Competition comes from local and regional newspapers, magazines, radio, broadcast and cable television, shoppers and other communications media that operate in the Company's markets. The extent and nature of such competition are, in large part, determined by the location and demographics of the markets targeted by a particular advertiser, and the number of media alternatives in those markets. Failure continually to improve the Company's current processes and to develop new products and services could result in the loss of the Company's customers to current or future competitors. In addition, failure to gain market acceptance of new products and services could adversely affect the Company's growth.

***Qualified Personnel* —** The Company believes that its future prospects will depend in large part upon its ability to attract, train and retain highly skilled technical, client services and administrative personnel. While dependent on employment levels and general economic conditions, qualified personnel historically have been in great demand and from time to time in the foreseeable future will likely remain a limited resource.

***Postal Rates* —** The Company's shoppers and direct and interactive marketing services depend on the United States Postal Service ("USPS") to deliver products. The Company's shoppers are delivered by standard mail, and postage is the second largest expense, behind payroll, in the Company's shopper business. The present standard postage rates went into effect in the third quarter of 2001 and are expected to increase in the second half of 2002. Future postage rates may also be impacted by the USPS's response to recent threats to the postal system. Overall shopper postage costs are expected to grow moderately as a result of this increase as well as anticipated increases in circulation and insert volumes. Postal rates also influence the demand for the Company's direct and interactive marketing services even though the cost of mailings is borne by the Company's customers and is not directly reflected in the Company's revenues or expenses.

***Paper Prices* —** Paper represents a substantial expense in the Company's shopper operations. Fluctuations in paper prices, such as those experienced in recent years, can materially affect the results of the Company's operations.

***Economic Conditions* —** Changes in national economic conditions, such as events following the September 11, 2001 attacks, can affect levels of advertising expenditures generally, and such changes can affect each of the Company's businesses. In addition, revenues from the Company's shopper business are dependent to a large extent on local advertising expenditures in the markets in which they operate. Such expenditures are substantially affected by the strength of the local economies in those markets. Direct and interactive marketing revenues are dependent on national and international economics.

***Interest Rates* —** Interest rate movements in Europe and the United States can affect the amount of interest the Company pays related to its debt and the amount it earns on cash equivalents. The Company's primary interest rate exposure is to interest rate fluctuations in Europe, specifically EUROLIBOR rates due to their impact on interest related to the Company's two $100 million credit facilities. The Company also has exposure to interest rate fluctuations in the United States, specifically commercial paper and overnight time deposit rates as these affect the Company's earnings on its excess cash.

Harte-Hanks, Inc. and Subsidiaries Consolidated Balance Sheets

December 31,

In thousands, except per share and share amounts	2001	2000
ASSETS		
Current assets		
Cash and cash equivalents	$ 30,468	$ 22,928
Accounts receivable *(less allowance for doubtful accounts of $5,463 in 2001 and $4,644 in 2000)*	138,409	179,838
Inventory	5,835	6,260
Prepaid expenses	13,411	14,072
Current deferred income tax asset	8,378	7,648
Other current assets	6,306	5,127
Total current assets	202,807	235,873
Property, plant and equipment		
Land	3,325	3,428
Buildings and improvements	31,045	28,374
Software	45,806	34,966
Equipment and furniture	178,842	171,560
	259,018	238,328
Less accumulated depreciation and amortization	(152,558)	(130,544)
	106,460	107,784
Construction and equipment installations in progress	2,968	4,281
Net property, plant and equipment	109,428	112,065
Intangible and other assets		
Goodwill and other intangibles *(less accumulated amortization of $83,092 in 2001 and $66,344 in 2000)*	438,325	439,148
Other assets	20,489	20,019
Total intangible and other assets	458,814	459,167
Total assets	$ 771,049	$ 807,105
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 42,990	$ 60,069
Accrued payroll and related expenses	21,550	31,429
Customer deposits and unearned revenue	38,617	42,712
Income taxes payable	10,531	5,135
Other current liabilities	8,086	10,619
Total current liabilities	121,774	149,964
Long-term debt	48,312	65,370
Other long-term liabilities *(including deferred income taxes of $29,515 in 2001 and $26,007 in 2000)*	48,597	40,768
Total liabilities	218,683	256,102
Stockholders' equity		
Common stock, $1 par value, authorized 250,000,000 shares		
Issued 2001: 78,281,458; 2000: 76,916,339 shares	78,281	76,916
Additional paid-in capital	219,229	202,222
Accumulated other comprehensive loss	(1,293)	(2,105)
Retained earnings	640,635	568,512
Less treasury stock, 2001: 16,139,795; 2000: 12,230,388 shares at cost	(384,486)	(294,542)
Total stockholders' equity	552,366	551,003
Total liabilities and stockholders' equity	$ 771,049	$ 807,105

See Notes to Consolidated Financial Statements

Harte-Hanks, Inc. and Subsidiaries Consolidated Statements of Operations

Year Ended December 31,

In thousands, except per share amounts	2001	2000	1999
Revenues	$ 917,928	$ 960,773	$ 829,752
Operating expenses			
Payroll	335,913	350,058	300,336
Production and distribution	313,639	336,444	306,340
Advertising, selling, general and administrative	79,826	92,330	70,060
Depreciation	32,079	28,494	24,126
Goodwill and intangible amortization	16,841	15,226	10,662
	778,298	822,552	711,524
Operating income	139,630	138,221	118,228
Other expenses (income)			
Interest expense	3,076	1,678	349
Interest income	(498)	(2,062)	(5,662)
Other, net	4,614	1,746	730
	7,192	1,362	(4,583)
Income before income taxes	132,438	136,859	122,811
Income tax expense	52,754	54,973	49,870
Net income	$ 79,684	$ 81,886	$ 72,941
Basic earnings per common share	$ 1.26	$ 1.21	$ 1.04
Weighted-average common shares outstanding	63,206	67,517	69,914
Diluted earnings per common share	$ 1.23	$ 1.18	$ 1.01
Weighted-average common and common equivalent shares outstanding	64,783	69,653	72,144

See Notes to Consolidated Financial Statements

Harte-Hanks, Inc. and Subsidiaries Consolidated Statements of Cash Flows

Year Ended December 31,

In thousands	2001	2000	1999
Cash Flows from Operating Activities			
Net income	$ 79,684	$ 81,886	$ 72,941
Adjustments to reconcile net income to net cash provided by operations:			
Depreciation	32,079	28,494	24,126
Goodwill and intangible amortization	16,841	15,226	10,662
Amortization of option-related compensation	206	441	430
Deferred income taxes	2,470	5,942	10,572
Other, net	4,464	424	224
Changes in operating assets and liabilities, net of effects from acquisitions and divestitures:			
(Increase) decrease in accounts receivable, net	47,578	(22,514)	(13,827)
(Increase) decrease in inventory	425	839	(848)
Increase in prepaid expenses and other current assets	(124)	(1,848)	(2,058)
Increase (decrease) in accounts payable	(17,054)	1,451	5,597
Increase (decrease) in other accrued expenses and other liabilities	(12,350)	5,095	10,826
Other, net	(1,278)	(4,511)	(3,281)
Net cash provided by operating activities	152,941	110,925	115,364
Cash Flows from Investing Activities			
Acquisitions	(28,230)	(43,873)	(136,469)
Purchases of property, plant and equipment	(26,445)	(36,465)	(28,928)
Proceeds from the sale of property, plant and equipment	492	432	976
Net sales and maturities of available-for-sale short-term investments	–	–	138,874
Other investing activities	801	391	(4,005)
Net cash used in investing activities	(53,382)	(79,515)	(29,552)
Cash Flows from Financing Activities			
Long-term borrowings	282,000	58,494	5,000
Payments on debt	(292,000)	(5,000)	–
Issuance of common stock	9,131	6,506	7,082
Issuance of treasury stock	75	81	87
Purchase of treasury stock	(83,664)	(92,706)	(87,574)
Warrants repurchased	–	(4,317)	–
Dividends paid	(7,561)	(6,736)	(5,578)
Net cash used in financing activities	(92,019)	(43,678)	(80,983)
Net increase (decrease) in cash	7,540	(12,268)	4,829
Cash and cash equivalents at beginning of period	22,928	35,196	30,367
Cash and cash equivalents at end of period	$ 30,468	$ 22,928	$ 35,196
Supplemental Cash Flow Information:			
Non-cash investing and financing activities:			
Acquisitions — debt issued (2000)	$ –	6,876	$ –

See Notes to Consolidated Financial Statements

Harte-Hanks, Inc. and Subsidiaries Consolidated Statements of Stockholders' Equity and Comprehensive Income

In thousands	Common Stock	Additional Paid-in Capital	Accumulated Deficit Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at January 1, 1999	$ 75,789	$ 189,698	$ 425,999	$ (114,395)	$ –	$ 577,091
Common stock issued — employee benefit plans	215	4,172	–	–	–	4,387
Exercise of stock options	388	2,307	–	–	–	2,695
Tax benefit of options exercised	–	1,253	–	–	–	1,253
Dividends paid ($0.08 per share)	–	–	(5,578)	–	–	(5,578)
Treasury stock issued	–	24	–	63	–	87
Treasury stock repurchase	–	–	–	(87,574)	–	(87,574)
Comprehensive income, net of tax:						
Net income	–	–	72,941	–	–	72,941
Change in unrealized gain (loss) on long-term investments, net of reclassification adjustments (net of tax of $6,632)	–	–	–	–	12,316	12,316
Total comprehensive income						85,257
Balance at December 31, 1999	76,392	197,454	493,362	(201,906)	12,316	577,618
Common stock issued — employee benefit plans	196	3,809	–	–	–	4,005
Exercise of stock options	328	2,173	–	–	–	2,501
Tax benefit of options exercised	–	1,581	–	–	–	1,581
Dividends paid ($0.10 per share)	–	–	(6,736)	–	–	(6,736)
Treasury stock issued	–	11	–	70	–	81
Treasury stock repurchase	–	–	–	(92,706)	–	(92,706)
Warrants repurchased (net of tax of $1,511)	–	(2,806)	–	–	–	(2,806)
Comprehensive income, net of tax:						
Net income	–	–	81,886	–	–	81,886
Foreign currency translation adjustment	–	–	–	–	(1,208)	(1,208)
Change in unrealized gain (loss) on long-term investments, net of reclassification adjustments (net of tax of $7,115)	–	–	–	–	(13,213)	(13,213)
Total comprehensive income						67,465
Balance at December 31, 2000	76,916	202,222	568,512	(294,542)	(2,105)	551,003
Common stock issued — employee benefit plans	177	3,275	–	–	–	3,452
Exercise of stock options	1,188	7,311	–	(6,350)	–	2,149
Tax benefit of options exercised	–	6,416	–	–	–	6,416
Dividends paid ($0.12 per share)	–	–	(7,561)	–	–	(7,561)
Treasury stock issued	–	5	–	70	–	75
Treasury stock repurchase	–	–	–	(83,664)	–	(83,664)
Comprehensive income, net of tax:						
Net income	–	–	79,684	–	–	79,684
Foreign currency translation adjustment	–	–	–	–	(85)	(85)
Change in unrealized gain (loss) on long-term investments, net of reclassification adjustments (net of tax of $481)	–	–	–	–	897	897
Total comprehensive income						80,496
Balance at December 31, 2001	$ 78,281	$ 219,229	$ 640,635	$ (384,486)	$ (1,293)	$ 552,366

See Notes to Consolidated Financial Statements

Note A — Significant Accounting Policies

Consolidation

The accompanying Consolidated Financial Statements present the financial position of Harte-Hanks, Inc. and subsidiaries (the "Company"). The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 revenues and expenses during the reporting periods.

All intercompany accounts and transactions have been eliminated in consolidation. Certain prior year amounts have been reclassified for comparative purposes.

Cash Equivalents and Available-for-Sale Securities

All highly liquid investments with an original maturity of 90 days or less at the time of purchase are considered to be cash equivalents. Cash equivalents are carried at cost, which approximates fair value. The Company considers its investments to be available-for-sale and has recorded its investments at fair value, with the unrealized gain (loss) recognized as a component of accumulated other comprehensive income.

Allowance for Doubtful Accounts

The Company maintains its allowance for doubtful accounts at a balance adequate to reduce accounts receivable to the amount of cash expected to be realized upon collection. The methodology used to determine the minimum allowance balance is based on the Company's prior collection experience and is generally related to the accounts receivable balance in various aging categories. The balance is also influenced by specific customers' financial strength and circumstance. Accounts that are determined to be uncollectible are written off in the period in which they are determined to be uncollectible. Periodic changes to the allowance balance are recorded as increases or decreases to bad debt expense, which is included in the "Advertising, selling, general and administrative" line of the Company's Consolidated Statements of Operations. The Company recorded bad debt expense of $4.4 million, $4.6 million and $1.8 million for the years ended December 31, 2001, 2000 and 1999, respectively.

Inventory

Inventory, consisting primarily of newsprint and operating supplies, is stated at the lower of cost (first-in, first-out method) or market.

Property, Plant and Equipment

Property, plant and equipment are stated on the basis of cost. Depreciation of buildings and equipment is computed generally on the straight-line method at rates calculated to amortize the cost of the assets over their useful lives. The general ranges of estimated useful lives are:

Buildings and improvements	10 to 40 years
Equipment and furniture	3 to 20 years
Software	3 to 10 years

Goodwill and Other Intangibles

Goodwill and other intangibles are stated on the basis of cost, adjusted as discussed below. Goodwill is amortized on a straight-line basis over 15 to 40 year periods. Other intangibles are amortized on a straight-line basis over a period of 5 to 10 years.

The Company assesses the recoverability of its goodwill and other intangibles by determining whether the amortization of the intangible balance over its remaining life can be recovered through projected undiscounted future cash flows over the remaining amortization period. If projected undiscounted future cash flows indicate that an unamortized intangible will not be recovered, an impairment loss is recognized based on projected discounted future cash flows. Cash flow projections are based on trends of historical performance and management's estimate of future performance, giving consideration to existing and anticipated competitive and economic conditions.

At December 31, 2001 and 2000 the Company's goodwill balance was $434.4 million, net of $82.0 million of accumulated amortization, and $434.7 million, net of $65.7 million of accumulated amortization, respectively.

Income Taxes

Income taxes are calculated using the asset and liability method required by Statement of Financial Accounting Standards ("SFAS") No. 109. Deferred income taxes are recognized for the tax consequences resulting from "timing differences" by applying enacted statutory tax rates applicable to future years. These "timing differences" are associated with differences between the financial and the tax basis of existing assets and liabilities. Under SFAS No. 109, a statutory change in tax rates will be recognized immediately in deferred taxes and income.

Earnings Per Share

Basic earnings per common share are based upon the weighted-average number of common shares outstanding. Diluted earnings per common share are based upon the weighted-average number of common shares outstanding and dilutive common stock equivalents from the assumed exercise of stock options using the treasury stock method.

Revenue Recognition

The Company recognizes revenue at the time the service is rendered or the product is delivered. Payments received in advance of the performance of services or delivery of the product are recorded as deferred revenue until such time as the services are performed.

Direct and interactive marketing revenue from the production and delivery of data is recognized upon completion and shipment of the work. Revenue from database subscriptions is recognized ratably over the term of the subscription. Service revenue from time-and-materials services is recognized as the services are provided. Revenue from certain service contracts is recognized over the contractual period, using the percentage-of-completion method based on individual costs incurred to date compared with total estimated contract costs. In other instances, progress toward completion is based on performance milestones specified in the contract where such milestones fairly reflect progress toward contract completion.

Revenue from software is recognized in accordance with the American Institute of Certified Public Accountants' (AICPA) Statement of Position ("SOP") 97-2 "Software Revenue Recognition," as amended by SOP 98-9 "Modification of SOP 97-2, Software Revenue Recognition". SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the vendor-specific objective evidence of fair values of the respective elements. In accordance with SOP 97-2, the Company has analyzed all of the elements included in its multiple-element arrangements and determined that it has Company-specific objective evidence of fair value to allocate revenue to the license and postcontract customer support (PCS) component of its software license arrangements. The revenue allocated to software products, including time-based software licenses, is recognized upon execution of a licensing agreement and shipment of the software or ratably over the term of the license, depending on the structure and terms of the arrangement. The revenue allocated to PCS is recognized ratably over the term of the support. Revenue allocated to professional services is recognized as the services are performed.

Shopper services are considered rendered when all printing, sorting, labeling and ancillary services have been provided and the mailing material has been received by the United States Postal Service.

Reserve for Workers Compensation, Automobile and General Liability

The Company has a $250,000 deductible for worker's compensation, automobile and general liability. The estimate of loss reserves necessary for claims is based on the Company's estimate of claims incurred as of the end of the year. The Company uses detail loss-run claim reports provided by the insurance administrator and applies actuarial development factors to the claim loss balance to determine an appropriate reserve balance. The loss-run claim reports show all claims and an estimate of what the claim will cost. This estimate is provided by the insurance administrator based upon their experience dealing with similar type claims. The Company uses the loss-run claim reports as a basis for its reserve balance. Periodic changes to the reserve are recorded as increases or decreases to insurance expense, which is included in the "Advertising, selling, general and administrative" line of the Company's Consolidated Statement of Operations.

Recent Accounting Pronouncement

In July 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations", and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 as well as all purchase method business combinations completed after June 30, 2001. SFAS No. 141 also specifies criteria intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill, noting that any purchase price allocable to an assembled workforce may not be accounted for separately. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of SFAS No. 142. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to be Disposed Of".

The Company adopted the provisions of SFAS No. 141 on July 1, 2001. The Company is required to adopt the provisions of SFAS No. 142 effective January 1, 2002, except that goodwill and intangible assets that were acquired in a business combination completed after June 30, 2001, and were determined to have an indefinite useful life, will not be amortized, but will continue to be evaluated for impairment in accordance with the appropriate pre-SFAS No. 142 accounting literature. Goodwill and intangible assets acquired in business combinations completed before July 1, 2001 were continued to be amortized during the period July 1, 2001 through December 31, 2001. SFAS No. 141 requires, upon adoption of SFAS No. 142, that the Company evaluate its existing intangible assets and goodwill that were acquired in a prior purchase business combination, and make any necessary reclassifications in order to conform with the new criteria in SFAS No. 141 for recognition apart from goodwill. Upon adoption of SFAS No. 142, the Company will be required to reassess the useful lives and residual values of all intangible assets acquired in purchase business combinations, and make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, the Company will be required to test the intangible asset for impairment in accordance with the provisions of SFAS No. 142 within the first interim period. Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

In connection with the transitional goodwill impairment evaluation, SFAS No. 142 will require the Company to perform an assessment of whether there is an indication that goodwill and equity-method goodwill is impaired as of the date of adoption. To accomplish this, the Company must identify its reporting units and determine the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of the date of adoption. The Company will then have up to six months from the date of adoption to determine the fair value of each reporting unit and compare it to the reporting unit's carrying amount. To the extent a reporting unit's carrying amount exceeds its fair value, an indication exists that the reporting unit's goodwill may be impaired and the Company must perform the second step of the transitional impairment test. In the second step, the Company must compare the implied fair value of the reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of its assets and liabilities (recognized and unrecognized) in a manner similar to a purchase price allocation in accordance with SFAS No. 141, to its carrying amount, both of which would be measured as of the date of adoption. This second step is required to be completed as soon as possible, but no later than the end of the year of adoption. Any transitional impairment loss will be recognized as the cumulative effect of a change in accounting principle in the Company's statement of operations.

As of the date of adoption, the Company has unamortized goodwill in the amount of $434.4 million and unamortized identifiable intangible assets in the amount of $3.9 million, all of which will be subject to the transition provisions of SFAS No. 141 and 142. Amortization expense related to goodwill was $16.2 million, $14.8 million and $10.6 million for the years ended December 31, 2001, 2000 and 1999, respectively. The Company expects to complete its initial impairment assessment during the second quarter of 2002. Based on its preliminary review, the Company does not expect to record any transitional goodwill impairment upon the completion of its initial impairment assessment.

Note B — Acquisitions/Divestitures

In November 2001, the Company acquired Sales Support Services, Inc. (SSS), a leading business-to-business lead generation, order processing and fulfillment services company to the automotive, energy and other industries. The total cost of the transaction was approximately $21.9 million, which was paid in cash and with the assumption of SSS's debt. Goodwill recognized in this transaction amounted to approximately $16.4 million, and was assigned to the direct and interactive marketing segment.

In November 2000, the Company acquired Detroit-based Information Resource Group, a leading provider of business-to-business intelligence solutions to the high-tech, telecommunications and other industries.

In June 2000, the Company acquired the UK based Hi-Tech Marketing Limited (HTM), a leading pan-European provider of CRM services to the high-tech, telecommunications and financial services industries.

In October 1999, the Company acquired ZD Market Intelligence, renamed Harte-Hanks Market Intelligence, for $101 million cash from Ziff-Davis, Inc. Harte-Hanks Market Intelligence is a leading provider of database products and solutions to the high-tech and telecommunications industries in the United States, Canada and Europe.

In June 1999, the Company acquired LYNQS Newmedia of Kansas City, Missouri, a developer of new media applications for the financial services, pharmaceutical and other industries.

In May 1999, the Company acquired Direct Marketing Associates, Inc. of Baltimore, Maryland, a leading provider of integrated direct marketing services to commercial, government and non-profit organizations.

The total cash outlay in 2001 for acquisitions was $28.2 million. In addition, the Company held back $1.0 million of the purchase price related to its November acquisition of SSS pending the final settlement of the acquired company's working capital amount. The total cash outlay in 2000 for acquisitions was $43.9 million. In addition, the Company incurred $6.9 million in notes payable for its June 2000 acquisition of HTM. The total cash outlay in 1999 for acquisitions was $136.5 million.

The operating results of the acquired companies have been included in the accompanying Consolidated Financial Statements from the date of acquisition under the purchase method of accounting. The Company has not disclosed proforma amounts including the operating results of SSS as they are not considered material to the Company as a whole.

Note C — Investments

Short-Term Investments

In 1999 the Company sold all of its short-term investments and at December 31, 2001, 2000 and 1999 held no such investments.

The gross realized gains and losses on the sale of short-term available-for-sale securities were immaterial for the year ended December 31, 1999.

Long-Term Investments

The Company made equity investments totaling $0.7 million and $4.0 million in 2000 and 1999, respectively. These investments were classified as other assets. All such investments for which fair value was readily determinable were considered to be available-for-sale and were recorded at fair value. The related unrealized gains and losses were reported as a separate component of accumulated other comprehensive income. All other equity investments were recorded at cost. Long-term investments for which the fair value was readily determinable at December 31, 2000 and 1999 consisted of the following:

	December 31, 2000		
In thousands	Original Cost	Gross Unrealized Gain (Loss)	Fair Value
Equity securities	$ 3,150	$ (1,380)	$ 1,770
Total	$ 3,150	$ (1,380)	$ 1,770

The Company sold all of these equity investments in 2001 and 2000, and owns no equity investments at December 31, 2001. Proceeds from the sale of long-term investments were $0.8 million and $1.1 million in 2001 and 2000, respectively. Gross realized losses included in 2001 income were $3.4 million and gross realized gains included in 2000 income were $0.5 million. Gross gains and losses were determined using the average cost method.

Note D — Long-Term Debt

Long-term debt consists of the following:

	December 31,	
In thousands	2001	2000
Revolving loan commitment, various interest rates (effective rate of 2.36% at December 31, 2001), due November 4, 2002	$ 45,000	$ 55,000
Revolving loan commitment, various interest rates (effective rate of 3.60% at December 31, 2001), $2.2 million due December 16, 2002, remaining $1.1 million due July 20, 2003	3,312	3,493
Acquisition note payable, various interest rates	–	6,877
Less current maturities	–	–
	$ 48,312	$ 65,370

Cash payments for interest were $3.4 million, $1.3 million and $0.1 million for the years ended December 31, 2001, 2000 and 1999, respectively.

Credit Facilities

On November 4, 1999 the Company obtained two unsecured revolving credit facilities. All borrowings under the $100 million revolving Three-Year Credit Agreement are to be repaid by November 4, 2002. On October 26, 2001 the Company was granted a 364-day extension to its $100 million revolving 364-Day Credit Agreement. All borrowings under the $100 million revolving 364-Day Credit Agreement are to be repaid by October 25, 2002 unless the Company requests and is granted another 364-day extension. Commitment fees on the total credit and interest rates for drawn amounts are determined according to a grid based on the Company's total debt to earnings ratio. Commitment fees range from .08% to .125% for the 364-day facility, and .1% to .15% for the three-year facility. Interest rates on drawn amounts range from EUROLIBOR plus .4% to EUROLIBOR plus .75%. These credit facilities contain both affirmative and negative covenants and the Company has been in compliance with these covenants since obtaining the credit facilities in 1999. As of December 31, 2001, the Company had $55 million and $100 million of unused borrowing capacity under its Three-Year Credit Agreement and 364-Day Credit Agreement, respectively. It is the Company's intent to obtain additional credit facilities at comparable amounts and terms at the time these two facilities expire.

On November 29, 1999 the Company obtained an unsecured credit facility in the amount of 2.5 million Euros for the purpose of financing the construction of a new building in Hasselt, Belgium. This facility was increased to 3.7 million Euros on July 18, 2000. All borrowings under the original facility amount are to be repaid by December 16, 2002 and any remaining outstanding amounts are to be repaid by July 20, 2003. The Company pays a commitment fee of .1% on the undrawn portion of the commitment. Interest rates on drawn amounts are at EURIBOR plus .15%. As of December 21, 2001, the Company had no unused borrowing capacity under this credit facility. It is the Company's intent to repay this note with borrowings under the additional credit facilities the Company intends to obtain at the expiration of its three-year and 364-day revolving credit facilities.

Acquisition Note Payable

In June 2000, the Company issued a note payable of 4.6 million British Pounds in connection with an acquisition. Interest on this note was at LIBOR minus .75%. This note payable was due upon demand, and was paid during 2001 using borrowings obtained from the Company's three-year revolving credit facility.

Note E — Income Taxes

The components of income tax expense (benefit) are as follows:

	Year Ended December 31,		
In thousands	2001	2000	1999
Current			
Federal	$ 43,010	$ 40,502	$ 32,099
State and local	6,776	6,679	6,079
Foreign	498	1,850	1,120
Total current	$ 50,284	$ 49,031	$ 39,298
Deferred			
Federal	$ 2,716	$ 5,321	$ 8,564
State and local	(246)	621	2,008
Total deferred	$ 2,470	$ 5,942	$ 10,572

The differences between total income tax expense and the amount computed by applying the statutory federal income tax rate to income before income taxes were as follows:

	Year Ended December 31,					
In thousands	2001		2000		1999	
Computed expected income tax expense	$ 46,353	35%	$ 47,900	35%	$ 42,984	35%
Net effect of state income taxes	4,368	3%	4,857	4%	5,256	4%
Effect of goodwill amortization	1,607	1%	1,633	1%	1,344	1%
Effect of non-taxable investment income	–	0%	–	0%	(50)	0%
Change in the beginning of the year balance of the valuation allowance	(124)	0%	(112)	0%	–	0%
Other, net	550	0%	695	0%	336	0%
Income tax expense for the period	$ 52,754	40%	$ 54,973	40%	$ 49,870	41%

Total income tax expense (benefit) was allocated as follows:

	Year Ended December 31,		
In thousands	2001	2000	1999
Results of operations	$ 52,754	$ 54,973	$ 49,870
Stockholders' equity	(5,935)	(10,207)	5,379
Total	$ 46,819	$ 44,766	$ 55,249

The tax effects of temporary differences that gave rise to significant portions of the deferred tax assets and deferred tax liabilities were as follows:

	December 31,	
In thousands	2001	2000
Deferred tax assets:		
Deferred compensation and retirement plans	$ 1,336	$ 2,430
Accrued expenses not deductible until paid	4,327	2,979
Accounts receivable, net	1,674	1,264
Other, net	162	806
State net operating loss carryforwards	759	455
Capital loss carryforward	492	–
Total gross deferred tax assets	8,750	7,934
Less valuation allowance	(897)	(455)
Net deferred tax assets	7,853	7,479
Deferred tax liabilities:		
Property, plant and equipment	(12,878)	(13,646)
Goodwill	(15,474)	(11,626)
State income tax	(638)	(566)
Total gross deferred tax liabilities	(28,990)	(25,838)
Net deferred tax liabilities	$ (21,137)	$ (18,359)

The valuation allowance for deferred tax assets as of January 1, 2000 was $475,000. The valuation allowance at December 31, 2001 relates to state net operating losses of $405,000 and capital losses of $492,000, which are not expected to be realized. The entire valuation allowance at December 31, 2000 related to state net operating losses that are not expected to be realized.

The net deferred tax asset (liability) is recorded both as a current deferred income tax asset and as other long-term liabilities based upon the classification of the related timing difference.

Cash payments for income taxes were $38.0 million, $47.8 million and $39.1 million in 2001, 2000 and 1999, respectively.

Note F — Employee Benefit Plans

Prior to January 1, 1999, the Company maintained a defined benefit pension plan for which most of its employees were eligible. In conjunction with significant enhancements to the Company's 401(k) plan, the Company elected to freeze benefits under this defined benefit pension plan as of December 31, 1998.

In 1994, the Company adopted a non-qualified, supplemental pension plan covering certain employees, which provides for incremental pension payments so that total pension payments equal those amounts that would have been payable from the Company's principal pension plan if it were not for limitations imposed by income tax regulation. The benefits under this supplemental pension plan will continue to accrue as if the principal pension plan had not been frozen.

The status of the Company's defined benefit pension plans at year-end was as follows:

In thousands	*Year ended December 31,* 2001	2000
Change in benefit obligation		
Benefit obligation at beginning of year	$ 85,369	$ 68,685
Service cost	543	338
Interest cost	6,045	5,373
Actuarial loss (gain)	(1,512)	15,729
Benefits paid	(4,453)	(4,756)
Benefit obligation at end of year	85,992	85,369
Change in plan assets		
Fair value of plan assets at beginning of year	90,356	101,679
Actual return on plan assets	(6,662)	(6,567)
Benefits paid	(4,453)	(4,756)
Fair value of plan assets at end of year	79,241	90,356
Funded status	(6,751)	4,987
Unrecognized actuarial loss	17,825	3,919
Unrecognized prior service cost	620	684
Net amount recognized	$ 11,694	$ 9,590

The Company's non-qualified pension plan has an accumulated benefit obligation in excess of its assets of $8.4 million at December 31, 2001.

The weighted-average assumptions used for measurement of the defined pension plans were as follows:

	December 31, 2001	2000	1999
Weighted-average assumptions as of December 31			
Discount rate	7.40%	7.50%	8.00%
Expected return on plan assets	9.00%	10.00%	10.00%
Rate of compensation increase	4.00%	4.00%	4.00%

Net pension cost for both plans included the following components:

In thousands	*December 31,* 2001	2000	1999
Components of net periodic benefit cost (income)			
Service cost	$ 543	$ 338	$ 365
Interest cost	6,045	5,373	5,215
Expected return on plan assets	(8,820)	(9,951)	(8,351)
Amortization of prior service cost	65	65	65
Recognized actuarial loss (gain)	64	(1,575)	151
Net periodic benefit income	$ (2,103)	$ (5,750)	$ (2,555)

Prior to January 1, 1999, the Company also sponsored several 401(k) plans to provide employees with additional income upon retirement. The Company generally matched a portion of employees' voluntary before-tax contributions. Employees were fully vested in their own contributions and generally vested in the Company's matching contributions upon three years of service. Effective January 1, 1999, changes were made that combined all 401(k) plans and allowed for immediate vesting of enhanced Company matching contributions. Total 401(k) expense recognized by the Company in 2001, 2000 and 1999 was $6.3 million, $6.2 million and $5.1 million, respectively.

The 1994 Employee Stock Purchase Plan provides for a total of 2,000,000 shares to be sold to participating employees at 85% of the fair market value at specified quarterly investment dates. Shares available for sale totaled 276,367 at December 31, 2001.

Note G — Stockholders' Equity

In January 2002, the Company announced an increase in the regular quarterly dividend from 3 cents per share to 3.5 cents per share, payable March 15, 2002 to holders of record on March 1, 2002.

During 2001 the Company repurchased 3.6 million shares of its common stock for $83.7 million under its stock repurchase program. In addition, the Company received .3 million shares of its common stock, with an estimated market value of $6.3 million, in exchange for proceeds related to stock option exercises. In September 2001, the Company authorized an increase of four million shares in the Company's stock repurchase program. As of December 31, 2001 the Company has repurchased 17.7 million shares since the beginning of its stock repurchase program in January 1997. During this period the Company has also received .3 million shares in exchange for proceeds related to stock option exercises. Under this program, the Company has authorization to repurchase an additional 4.9 million shares.

Note H — Stock Option Plans

1984 Plan

In 1984, the Company adopted a Stock Option Plan ("1984 Plan") pursuant to which it issued to officers and key employees options to purchase shares of common stock at prices equal to the market price on the grant date. Market price was determined by the Board of Directors for purposes of granting stock options and making repurchase offers. Options granted under the 1984 Plan became exercisable five years after date of grant. There were no remaining options outstanding under the 1984 Plan at December 31, 2001. At December 31, 2000 and 1999, options to purchase 126,000 shares and 216,000 shares, respectively, were outstanding under the 1984 Plan. No additional options will be granted under the 1984 Plan.

1991 Plan

The Company adopted the 1991 Stock Option Plan ("1991 Plan") pursuant to which it may issue to officers and key employees options to purchase up to 8,000,000 shares of common stock. Options have been granted at prices equal to the market price on the grant date ("market price options") and at prices below market price ("performance options"). As of December 31, 2001, 2000 and 1999, market price options to purchase 6,033,187 shares, 6,597,025 shares and 5,873,475 shares, respectively, were outstanding with exercise prices ranging from $3.33 to $26.19 per share at December 31, 2001. Market price options granted prior to January 1998 become exercisable after the fifth anniversary of their date of grant. Beginning January 1998, market price options generally become exercisable in 25% increments on the second, third, fourth and fifth anniversaries of their date of grant. The weighted-average exercise price for outstanding market price options and exercisable market price options at December 31, 2001 was $16.49 and $10.86, respectively. The weighted-average remaining life for outstanding market price options was 5.94 years.

At December 31, 2001, 2000 and 1999, performance options to purchase 501,250 shares, 716,600 shares and 739,400 shares, respectively, were outstanding with exercise prices ranging from $0.33 to $2.00 per share at December 31, 2001. Performance options become exercisable in whole or in part after three years, and the extent to which they become exercisable at that time depends upon the extent to which the Company achieves certain goals established at the time the options are granted. That portion of the performance options which does not become exercisable at an earlier date becomes exercisable after the ninth anniversary of the date of grant. Compensation expense of $0.2 million, $0.4 million and $0.4 million was recognized for the performance options for the years ended December 31, 2001, 2000 and 1999, respectively. The weighted-average exercise price for outstanding options and exercisable options at December 31, 2001 was $0.61 and $0.49, respectively. The weighted-average remaining life for outstanding performance options was 2.80 years. The Company did not grant any performance options during 2001 or 2000.

DiMark

In connection with the DiMark merger, DiMark's outstanding stock options were converted into options to acquire approximately 3.0 million shares of Harte-Hanks common stock. There were no outstanding DiMark options as of December 31, 2001 and 2000. As of December 31, 1999, there were 54,792 DiMark options outstanding.

The following summarizes all stock option plans activity during 2001, 2000 and 1999:

	Number Of Shares	Weighted Average Option Price
Options outstanding at January 1, 1999	6,306,914	$ 9.72
Granted	1,575,350	22.29
Exercised	(388,097)	6.76
Cancelled	(610,500)	17.88
Options outstanding at December 31, 1999	6,883,667	12.04
Granted	1,163,600	22.01
Exercised	(327,992)	7.37
Cancelled	(279,650)	20.20
Options outstanding at December 31, 2000	7,439,625	13.50
Granted	821,100	22.21
Exercised	(1,188,288)	7.26
Cancelled	(538,000)	21.29
Options outstanding at December 31, 2001	6,534,437	$ 17.73
Exercisable at December 31, 2001	2,908,561	$ 9.30

The Company has adopted the disclosure-only provisions of SFAS No. 123, "Accounting For Stock-Based Compensation." Accordingly, no compensation expense has been recognized for options granted where the exercise price is equal to the market price of the underlying stock at the date of grant. For options issued with an exercise price below the market price of the underlying stock on the date of grant, the Company recognizes compensation expense under the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, as permitted under SFAS No. 123.

Had compensation expense for the Company's options been determined based on the fair value at the grant date for awards since January 1, 1995, consistent with the provisions of SFAS No. 123, the Company's net income and diluted earnings per share would have been reduced to the pro forma amounts indicated below.

In thousands except per share amounts	*Year ended December 31,* 2001	2000	1999
Net income — as reported	$ 79,684	$ 81,866	$ 72,941
Net income — pro forma	75,446	77,245	68,923
Diluted earnings per share — as reported	1.23	1.18	1.01
Diluted earnings per share — pro forma	1.16	1.11	0.95

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2001, 2000 and 1999:

	Year ended December 31, 2001	2000	1999
Expected dividend yield	0.5%	0.4%	0.3%
Expected stock price volatility	21.0%	23.0%	22.0%
Risk free interest rate	6.0%	6.0%	6.0%
Expected life of options	3-10 years	3-10 years	3-10 years

The weighted-average fair value of market price options granted during 2001, 2000 and 1999 was $8.02, $9.66 and $9.24, respectively. The weighted-average fair value of performance options granted during 1999 was $22.54. The Company did not grant any performance options during 2001 or 2000.

Note I — Fair Value of Financial Instruments

Because of their maturities and/or variable interest rates, certain financial instruments of the Company have fair values approximating their carrying values. These instruments include revolving credit agreements, accounts receivable, trade payables, and miscellaneous notes receivable and payable. The Company's equity securities that have a readily determinable fair value are recorded at fair value. (See Note C.)

Note J — Commitments and Contingencies

At December 31, 2001, the Company had outstanding letters of credit in the amount of $8.4 million. These letters of credit exist to support the Company's insurance programs relating to worker's compensation, automobile and general liability, and leases.

Note K — Leases

The Company leases certain real estate and equipment under various operating leases. Most of the leases contain renewal options for varying periods of time. The total rent expense applicable to operating leases was $28.5 million, $26.3 million and $23.0 million for the years ended December 31, 2001, 2000 and 1999, respectively.

The future minimum rental commitments for all non-cancelable operating leases with terms in excess of one year as of December 31, 2001 are as follows:

In thousands	
2002	$ 26,696
2003	21,313
2004	15,344
2005	11,170
2006	6,913
After 2006	23,538
	$ 104,974

Note L — Earnings Per Share

A reconciliation of basic and diluted earnings per share (EPS) is as follows:

In thousands except per share amounts	Year ended December 31, 2001	2000	1999
BASIC EPS			
Net income	$ 79,684	$ 81,886	$ 72,941
Weighted-average common shares outstanding used in earnings per share computations	63,206	67,517	69,914
Earnings per share	$ 1.26	$ 1.21	$ 1.04
DILUTED EPS			
Net income	$ 79,684	$ 81,886	$ 72,941
Shares used in diluted earnings per share computations	64,783	69,653	72,144
Earnings per share	$ 1.23	$ 1.18	$ 1.01
Computation of Shares Used in Earnings Per Share Computations			
Average outstanding common shares	63,206	67,517	69,914
Average common equivalent shares — dilutive effect of option shares	1,577	2,136	2,230
Shares used in diluted earnings per share computations	64,783	69,653	72,144

As of December 31, 2001 the Company had 363,798 antidilutive market price options outstanding, which have been excluded from the EPS calculations

Note M — Selected Quarterly Data (Unaudited)

In thousands, except per share amounts	2001 Quarter Ended December 31	September 30	June 30	March 31	2000 Quarter Ended December 31	September 30	June 30	March 31
Revenues	$ 233,024	$ 224,130	$ 228,654	$ 232,120	$ 255,818	$ 243,205	$ 235,693	$ 226,057
Operating income	35,173	36,046	36,559	31,852	36,824	35,400	35,846	30,151
Net income	20,572	19,913	20,836	18,363	21,605	21,132	21,395	17,754
Basic earnings per share	0.33	0.32	0.33	0.28	0.33	0.31	0.31	0.26
Diluted earnings per share	0.32	0.31	0.32	0.28	0.32	0.30	0.30	0.25

Note N — Business Segments

Harte-Hanks is a highly focused targeted media company with operations in two segments – direct and interactive marketing and shoppers.

The Company's direct and interactive marketing segment offers a complete range of specialized, coordinated and integrated direct marketing services from a single source. CRM and Marketing Services are provided in the direct and interactive marketing segment. CRM revenues were $380.8 million, $419.5 million and $335.5 million in 2001, 2000 and 1999, respectively. Marketing Services' revenues were $221.1 million, $242.5 million and $223.8 million in 2001, 2000 and 1999, respectively. The Company utilizes advanced technologies to enable its customers to identify, reach and influence specific consumers or businesses. The Company's direct and interactive marketing capabilities also strengthen the relationship between its clients and their customers. The Company constructs and updates business-to-business and business-to-consumer databases; accesses the data through flexible hosting capabilities and analyzes it to help make it relevant; applies the knowledge by putting the data to work via multi-channel programs; and, executes those programs through marketing services delivery campaigns. The Company's direct and interactive marketing customers include many of America's largest retailers; financial companies including banks, financing companies, mutual funds and insurance companies; high-tech and telecommunications companies; and pharmaceutical companies and healthcare organizations. Direct and interactive marketing customers also include a growing number of customers in such selected markets as automotive, utilities, consumer packaged goods, hospitality, publishing, business services, energy and government/not-for-profit. The segment's client base is both domestic and international.

The Company's shoppers segment produces weekly advertising publications primarily delivered free by third-class mail to all households in a particular geographic area. Shoppers offer advertisers a targeted, cost-effective local advertising system, with virtually 100% penetration in their area of distribution. Shoppers are particularly effective in large markets with high media fragmentation in which major metropolitan newspapers generally have low penetration.

Included in Corporate Activities are general corporate expenses. Assets of Corporate Activities include unallocated cash and investments and deferred income taxes.

Information as to the operations of Harte-Hanks in different business segments is set forth below based on the nature of the products and services offered. Harte-Hanks evaluates performance based on several factors, of which the primary financial measures are segment revenues and operating income. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies (Note A).

The operating results of Harte-Hanks Direct Marketing include the acquisition of Sales Support Services, Inc. in November 2001.

Note N — Business Segments (continued)

Information about the Company's operations in different industry segments:

Year Ended December 31,

In thousands	2001	2000	1999
Revenues			
Direct Marketing	$ 601,901	$ 662,044	$ 559,262
Shoppers	316,027	298,729	270,490
Total Revenues	$ 917,928	$ 960,773	$ 829,752
Operating income			
Direct Marketing	$ 85,020	$ 91,450	$ 79,164
Shoppers	63,398	55,710	47,015
Corporate Activities	(8,788)	(8,939)	(7,951)
Total operating income	$ 139,630	$ 138,221	$ 118,228
Income before income taxes			
Operating income	$ 139,630	$ 138,221	$ 118,228
Interest expense	(3,076)	(1,678)	(349)
Interest income	498	2,062	5,662
Other, net	(4,614)	(1,746)	(730)
Total income before income taxes	$ 132,438	$ 136,859	$ 122,811
Depreciation			
Direct Marketing	$ 26,769	$ 23,022	$ 18,804
Shoppers	5,235	5,393	5,235
Corporate Activities	75	79	87
Total depreciation	$ 32,079	$ 28,494	$ 24,126
Goodwill and intangible amortization			
Direct Marketing	$ 12,769	$ 11,156	$ 6,593
Shoppers	4,072	4,070	4,069
Total goodwill and intangible amortization	$ 16,841	$ 15,226	$ 10,662
Total assets			
Direct Marketing	$ 536,270	$ 589,552	
Shoppers	179,748	187,905	
Corporate Activities	55,031	29,648	
Total assets	$ 771,049	$ 807,105	
Capital expenditures			
Direct Marketing	$ 22,354	$ 34,030	$ 24,450
Shoppers	4,085	2,408	4,434
Corporate Activities	6	27	44
Total capital expenditures	$ 26,445	$ 36,465	$ 28,928

Information about the Company's operations in different geographic areas:

Year Ended December 31,

In thousands	2001	2000	1999
Revenues[a]			
United States	$ 880,642	$ 917,160	$ 800,700
Other countries	37,286	43,613	29,052
Total revenues	$ 917,928	$ 960,773	$ 829,752
Long-lived assets[b]			
United States	$ 101,785	$ 104,507	
Other countries	7,643	7,558	
Total long-lived assets	$ 109,428	$ 112,065	

a Geographic revenues are based on the location of the customer.
b Long-lived assets are based on physical location.

Five-Year Financial Summary

In thousands, except per share amounts	2001	2000	1999	1998	1997
Statement of Operations Data					
Revenues	$ 917,928	$ 960,773	$ 829,752	$ 748,546	$ 638,349
Operating expenses					
Payroll, production and distribution	649,552	686,502	606,676	553,529	479,742
Selling, general and administrative	79,826	92,330	70,060	64,082	59,054
Depreciation	32,079	28,494	24,126	21,087	17,327
Goodwill and intangible amortization	16,841	15,226	10,662	7,890	5,134
Total operating expenses	778,298	822,552	711,524	646,588	561,257
Operating income	139,630	138,221	118,228	101,958	77,092
Interest expense, net	2,578	(384)	(5,313)	(13,281)	1,777
Income from continuing operations[a]	79,684	81,886	72,941	68,371[b]	44,271[c]
Income from continuing operations after extraordinary items, net of taxes	79,684	81,886	72,941	68,371	43,396[d]
Earnings from continuing operations per common share — diluted	1.23	1.18	1.01	0.90[b]	0.57[c]
Earnings from continuing operations after extra-ordinary items per common share — diluted	1.23	1.18	1.01	0.90[b]	0.56[d]
Cash dividends per common share	0.12	0.10	0.08	0.06	0.04
Weighted-average common and common equivalent shares outstanding — diluted	64,783	69,653	72,144	76,057	77,000
Segment Data					
Revenues					
Direct Marketing	$ 601,901	$ 662,044	$ 559,262	$ 493,898	$ 425,489
Shoppers	316,027	298,729	270,490	254,648	212,860
Total revenues	$ 917,928	$ 960,773	$ 829,752	$ 748,546	$ 638,349
Operating income					
Direct Marketing	$ 85,020	$ 91,450	$ 79,164	$ 69,648	$ 54,360
Shoppers	63,398	55,710	47,015	40,507	31,089
General corporate	(8,788)	(8,939)	(7,951)	(8,197)	(8,357)
Total operating income	$ 139,630	$ 138,221	$ 118,228	$ 101,958	$ 77,092
Other Data					
Operating cash flow[e]	$ 188,550	$ 181,941	$ 153,016	$ 130,935	$ 99,553
Capital expenditures	26,445	36,465	28,928	24,443	28,396
Balance Sheet Data (at end of period)					
Property, plant and equipment, net	$ 109,428	$ 112,065	$ 106,250	$ 92,274	$ 89,351
Goodwill and other intangibles, net	438,325	439,148	409,791	290,831	250,363
Total assets	771,049	807,105	769,427	715,213	954,923
Total long term debt	48,312	65,370	5,000	–	–
Total stockholders' equity	552,366	551,003	577,618	577,091	566,237

a Represents income and earnings from continuing operations per common share before extraordinary items.
b Includes non-recurring pension gain of $1.3 million, or two cents per share, net of $0.8 million income tax expense. Excluding this gain, earnings were $0.88 per share.
c Includes non-recurring income of $0.4 million, or one-half cent per share, net of $0.4 million income tax expense related to the sale of stock in another company partially offset by other non-recurring items. Excluding this income, earnings were $0.57 per share.
d Includes extraordinary loss from the early extinguishment of debt of $0.9 million, net of $0.6 million income tax benefit.
e Operating cash flow is defined as operating income plus depreciation and goodwill and intangible amortization. Operating cash flow is not intended to represent cash flow or any other measure of performance in accordance with accounting principles generally accepted in the United States of America.

Independent Auditors' Report

The Board of Directors and Stockholders
Harte-Hanks, Inc.:

We have audited the accompanying consolidated balance sheets of Harte-Hanks, Inc. and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of operations, cash flows, and stockholders' equity and comprehensive income for each of the years in the three-year period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Harte-Hanks, Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

San Antonio, Texas

January 29, 2002

Corporate Information

Common Stock

The Company's common stock is listed on the New York Stock Exchange (symbol: HHS). The quarterly stock price ranges for 2001 and 2000 were as follows:

	2001		2000	
	High	Low	High	Low
First Quarter	24.09	21.28	26.75	19.63
Second Quarter	25.88	21.36	25.94	21.00
Third Quarter	24.90	20.50	27.88	24.38
Fourth Quarter	28.92	20.45	28.44	21.50

In 2001, quarterly dividends were paid at the rate of 3 cents per share. In 2000, quarterly dividends were paid at the rate of 2.5 cents per share.

There are approximately 2,700 holders of record.

Transfer Agent and Registrar
EquiServe Trust Company, N.A.
PO Box 43010
Providence, RI 02940-3010

Annual Meeting of Stockholders
The annual meeting of stockholders will be held at 10:00 a.m. on May 7, 2002, at 200 Concord Plaza Drive, First Floor, San Antonio, Texas.

Form 10-K Annual Report
A copy of the Company's annual report to the Securities and Exchange Commission on Form 10-K may be obtained, without charge, upon written request to:

Dean Blythe, Secretary
Harte-Hanks, Inc.
P. O. Box 269
San Antonio, Texas 78291-0269

DIRECTORS

DAVID L. COPELAND
President, SIPCO, Inc.

DR. PETER T. FLAWN
President Emeritus
The University of Texas at Austin
Chairman, Audit Committee

LARRY FRANKLIN
Chairman and Chief Executive Officer

CHRISTOPHER M. HARTE
Private Investor

HOUSTON H. HARTE
Vice Chairman

RICHARD HOCHHAUSER
President and Chief Operating Officer

JAMES L. JOHNSON
Chairman Emeritus,
GTE Corporation
Chairman, Compensation Committee

WILLIAM K. GAYDEN
Chairman and Chief Executive Officer,
Merit Energy Company

OFFICERS

LARRY FRANKLIN
Chairman and
Chief Executive Officer

RICHARD HOCHHAUSER
President and
Chief Operating Officer

CRAIG COMBEST
Senior Vice President,
Direct Marketing

DONALD CREWS
Senior Vice President,
Legal and Secretary

CHARLES DALL'ACQUA
Senior Vice President, Direct Marketing

PETER GORMAN
Senior Vice President, Shoppers

JACQUES KERREST
Senior Vice President,
Finance and Chief Financial Officer

GARY SKIDMORE
Senior Vice President, Direct Marketing

DEAN BLYTHE
Vice President, Legal

KATHY CALTA
Vice President, Direct Marketing

BILL CARMAN
Vice President, Shoppers

JAMES DAVIS
Vice President, Direct Marketing

BILL GOLDBERG
Vice President, Direct Marketing

SPENCER JOYNER, JR.
Vice President, Direct Marketing

FEDERICO ORTIZ
Vice President, Tax

TANN TUELLER
Vice President, Direct Marketing

JESSICA HUFF
Controller and
Chief Accounting Officer

CORPORATE OFFICE

SAN ANTONIO, TEXAS

http://www.harte-hanks.com

DIRECTORY MARKETING

<u>DIRECT MARKETING</u>

CRM
Austin, Texas
Billerica, Massachusetts
Clearwater, Florida
Fort Worth, Texas
Glen Burnie, Maryland
La Jolla, California
Lake Katrine, New York
Lake Mary, Florida
Monroe Township, New Jersey
New York, New York
Ontario, California
River Edge, New Jersey
San Diego, California
Sterling Heights, Michigan
Valencia, California
West Bridgewater, Massachusetts

MARKETING SERVICES
Baltimore, Maryland
Bellmawr, New Jersey
Bloomfield, Connecticut
Cherry Hill, New Jersey
Cincinnati, Ohio
Clearwater, Florida
Deerfield Beach, Florida
Forty Fort, Pennsylvania
Fullerton, California
Grand Prairie, Texas
Jacksonville, Florida
Langhorne, Pennsylvania
Memphis, Tennessee
Shawnee, Kansas
Westville, New Jersey

NATIONAL SALES HEADQUARTERS
Cincinnati, Ohio

INTERNATIONAL OFFICES
Darmstadt, Germany
Dublin, Ireland
Hasselt, Belgium
London, United Kingdom
Madrid, Spain
Melbourne, Australia
São Paulo, Brazil
Sevres, France
Toronto, Canada
Uxbridge, United Kingdom

<u>SHOPPERS</u>

THE FLYER
South Florida
http://www.theflyer.com

PENNYSAVER
Northern California

Southern California —
Greater Los Angeles Area

Southern California —
Greater San Diego Area

http://www.pennysaverusa.com

P.O. Box 269
San Antonio, TX 78291-0269
(210) 829-9000

www.harte-hanks.com

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