Harte-Hanks, Inc.

2002 Annual Report

REAL BUSINESS 2 | REAL RESULTS 6 | REAL VERTICAL MARKET EXPERTISE 9

REAL MISSION 10 | REAL FINANCIAL STRENGTH 11

What is real?

The environment that we and our clients encountered, and the way we reacted, managed and sought to grow were the real issues Harte-Hanks faced in 2002. And we responded with solid performance while laying the groundwork for future growth.

The approximately 7,000 employees of Harte-Hanks met the year's challenges with energy and passion, rolling up their sleeves to produce results. Measurable results. Results grounded in an unwavering commitment to tangible, quantifiable information—real-world information used to drive the responses, decisions and behavior of real people who are in the market for our clients' products and services.

In Direct Marketing and in Shoppers, the people of Harte-Hanks are the people who "make it happen."

REAL BUSINESS

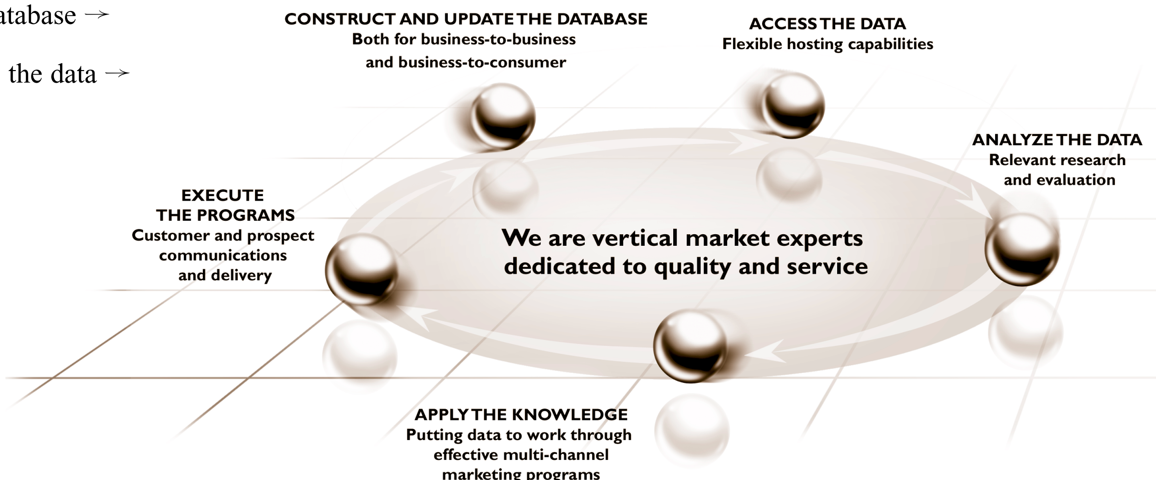
Born in the 1920s as a West Texas newspaper company, today Harte-Hanks is a worldwide direct marketing and targeted media company that provides direct marketing services and shopper advertising opportunities to a wide range of local, regional, national and international clients. Our clients include many Fortune 1000 companies in consumer and business-to-business markets across North America, Europe, South America and the Pacific Rim, as well as thousands of smaller retailers, service companies and individuals who use the effective targeting capabilities of our shopper publications in California and Florida.

Direct Marketing: real solutions

The people of Harte-Hanks deliver best-of-breed solutions—individual or linked end-to-end—enabling our clients to sell more products and services to current customers and to acquire new customers. At the same time, these solutions create insights and knowledge about the real-world purchasing behavior and preferences of customers that are used to continually refine marketing models and business decisions.

Harte-Hanks Direct Marketing improves the return on our clients' marketing investment with a range of services organized around five solution points:

Construct and update the database →
Access the data → Analyze the data →
Apply the knowledge →
Execute the programs.
We are experts at each element in this process, highly skilled at tailoring solutions for each of the vertical markets we serve.



Shoppers: real solutions

Harte-Hanks is North America's largest owner, operator and distributor of shopper publications. Each week the company's two primary titles, *PennySaver* and *The Flyer*, provide relevant advertising to more than 10 million households in California and Florida.

Harte-Hanks Shoppers target prospective customers by geographic zone, clusters of geographic zones within a radius of advertiser location, demographic criteria, and even lifestyle or language. Shoppers meet local business needs with great flexibility, offering many ways to advertise in the print publication as well as online versions that include interactive search functions. The Harte-Hanks employees who contribute to the creation of our shopper publications deliver high-quality, cost-efficient solutions to a wide range of residential advertisers and local, regional and national businesses. It's the energy and passion of those employees that enable thousands of local organizations to market successfully in a respected, branded environment—at a cost that's often less than a penny per household.

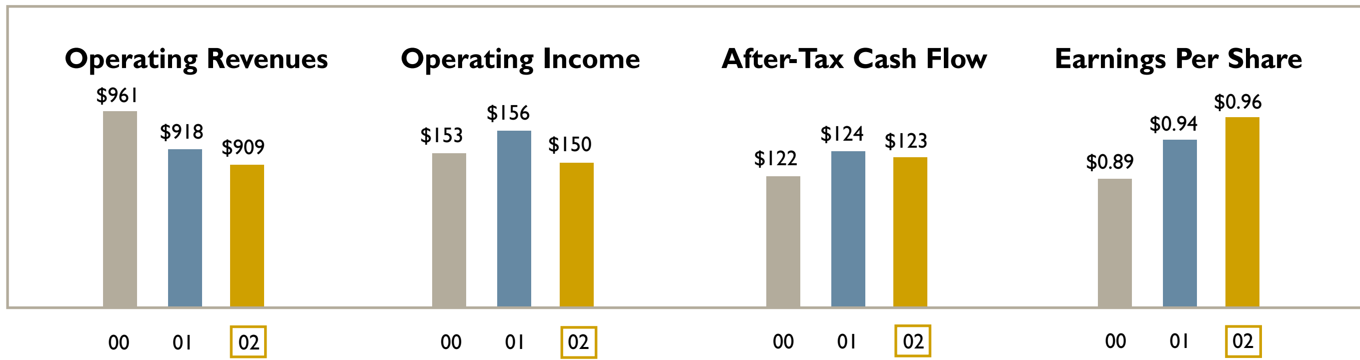
FINANCIAL HIGHLIGHTS *(in thousands, except per share amount)*

	2002	2001[1]	2000[1]
Revenues	$ 908,777	$ 917,928	$ 960,773
Operating income	150,288	155,853	153,014
Depreciation and amortization	32,728	32,697	28,927
Operating cash flow (operating income plus depreciation and amortization)	183,016	188,550	181,941
After-tax cash flow (net income plus depreciation and amortization)	123,473	124,397	121,565
Interest expense	1,208	3,076	1,678
Net income	90,745	91,700	92,638
Diluted earnings per share	0.96	0.94	0.89
Capital expenditures	17,358	26,445	36,465
Average common and common equivalent shares outstanding—diluted[2]	94,872	97,174	104,480

1 Results as if SFAS 142 had been adopted for the period. Reported results for the year ended December 31, 2001, including goodwill amortization, were operating income of $139,630, goodwill amortization of $16,223, operating cash flow of $188,550, after-tax cash flow of $128,604, net income of $79,684 and diluted earnings per share of $0.82. Reported results for the year ended December 31, 2000, including goodwill amortization, were operating income of $138,221, goodwill amortization of $14,793, operating cash flow of $181,941, after-tax cash flow of $125,606, net income of $81,886 and diluted earnings per share of $0.78.

2 Harte-Hanks completed a three-for-two split of its common stock in the form of a 50% stock dividend in May 2002. All share and per share amounts presented have been adjusted to reflect this three-for-two split.

FINANCIAL HIGHLIGHTS *(in millions, except per share amounts)*



Data leading to insights...insights to action

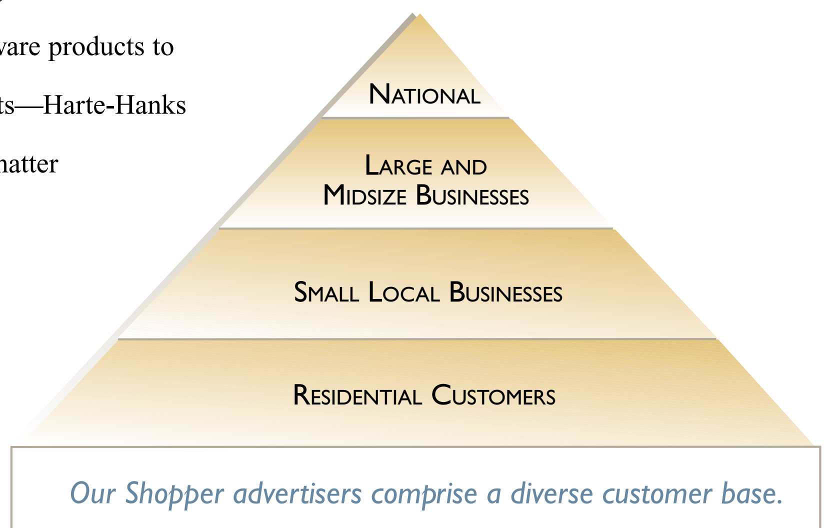
At Harte-Hanks, our everyday business is putting information to work. The knowledge we gain for clients through the data we capture, analyze and disseminate gives them a crucial edge in developing the content of marketing messages, evaluating media channels and assessing variables such as timing, pricing strategies and target audiences. Our proficiency at transforming data into knowledge helps refine marketing communications continually and comprehensively.

The insights we give clients are real and measurable. We help them use these insights and data to create strategies that reflect the demands of reality. The marketplaces of the 21st century are challenging and competitive. Better targeting means better return on our clients' investments. In short, Harte-Hanks enables companies to market smarter.

World-class solutions

Harte-Hanks offers specialized services that are coordinated and integrated to drive traffic to a physical location, call or contact center, or Web site. From Web applications to personalized mail, teleservices to e-mail, direct agency capabilities to print on demand, desktop databases to a range of Allink® database applications, fulfillment to customer care, proprietary software products to hosting solutions, shopper run-of-press advertising to inserts—Harte-Hanks has what it takes to meet our clients' marketing needs, no matter how complex.

Our solutions are tested in the real world each day. We balance the tried and true with the most promising of the cutting edge, demonstrating strength in all direct and interactive media.



Our Shopper advertisers comprise a diverse customer base.

Real capabilities for a tough world

The wide range of Harte-Hanks solutions is supported by our worldwide presence. We create solutions everywhere our clients do business. With a growing portfolio of data access tools, we construct databases and provide flexible Web-enabled hosting. We strategically analyze the data and apply the knowledge gained, turning insight into action through the execution of marketing programs. We provide business-to-business response management solutions. We create and execute targeted mailings that deliver results. We create award-winning Web sites. We provide individual marketing solutions and weave them into seamless end-to-end marketing programs—anywhere in the world.

We optimize the cost-effectiveness of each marketing program we invent or touch. Today, marketers need this support and expertise more than ever, when customers—smarter, better informed, more opportunistic than loyal—keep demanding higher levels of satisfaction from the companies with which they do business. From Fortune 1000 companies to the thousands of small businesses that depend on our shopper publications, our clients rely on Harte-Hanks to produce real results. And we come through for them every day.

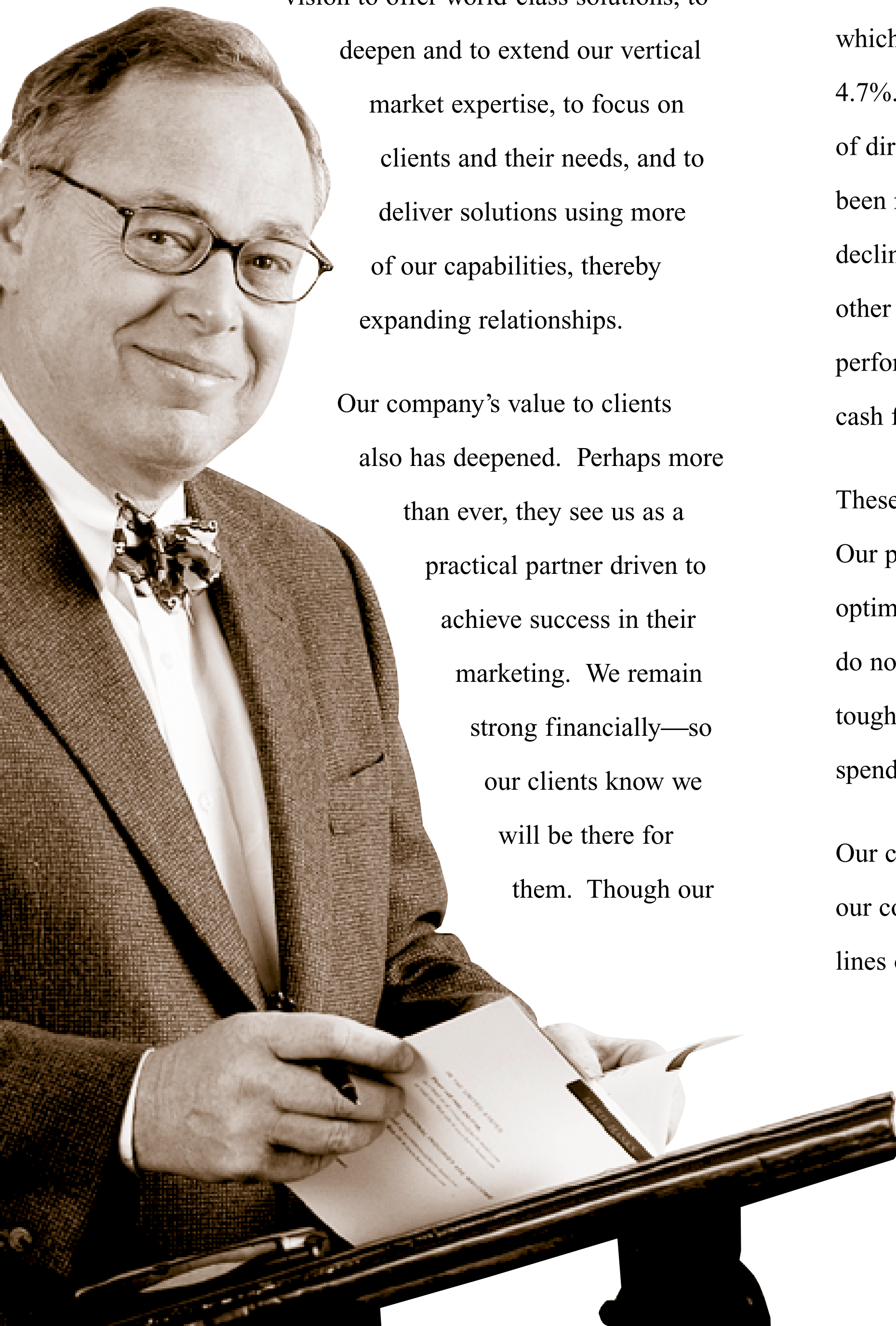
While staying focused on day-to-day details of our clients' issues, Harte-Hanks always remembers the big picture. We apply the insights we gain in one business sector to hone our expertise in another. For instance, the direct marketing industry recognizes our proprietary Trillium Software System® as the most effective way to ensure the best data quality across vertical markets—for customer relationship management, e-business, data warehouses and operational data stores. In many areas, we now offer shopper customers more in-the-book color advertising.

REAL RESULTS

To our shareholders

Harte-Hanks offers marketers real solutions that garner real results. It's that type of return, which our own people provide every day, that keeps our clients coming back.

In the second full calendar year of sluggish performance by the U.S. and world economies, Harte-Hanks and its approximately 7,000 employees continued to perform in extraordinary fashion. All of them have embraced our vision to offer world-class solutions, to deepen and to extend our vertical market expertise, to focus on clients and their needs, and to deliver solutions using more of our capabilities, thereby expanding relationships.



Our company's value to clients also has deepened. Perhaps more than ever, they see us as a practical partner driven to achieve success in their marketing. We remain strong financially—so our clients know we will be there for them. Though our competitors are resilient, our ability to provide end-to-end marketing strategy and execution makes our Direct Marketing team unique. Our clients increasingly recognize our best-of-breed solutions as the ones that meet many of their needs. And our leadership in Shoppers continues to expand with another year of outstanding performance. To our clients, the value we provide is what makes us real.

In 2002, diluted earnings per share were up 2.1% to $0.96 on revenues of $908.8 million. In Direct Marketing—which comprised 63% of total revenue—revenue decreased 4.7%. While marketers continue to invest in a wide range of direct marketing solutions, these expenditures have been reduced. Operating cash flow for Direct Marketing declined 10.4%. In Shoppers—which now comprise the other 37% of total revenue—our team posted superb performance, with revenue gaining 6.0% and operating cash flow up 9.4%.

These figures are respectable, given the current climate. Our people, once again, responded to our challenge to optimize revenue and maintain cost controls. Still, we do not mark a return to heady times. Traction remains tough to achieve. Direction is hard to read. Business spending is understandably tight.

Our company is investing in its own future by developing our core competencies, as well as extending our existing lines of business. New strategic initiatives in Direct Marketing reflect our expertise in such areas as global and multichannel data quality, customer data management, marketing portals, e-marketing and our CI Technology Database, among others.

Richard Hochhauser, President and Chief Executive Officer

This is about market leadership, meeting client needs and driving future revenue. While we did not make any acquisitions in 2002, we remain committed to doing so. We continue to evaluate opportunities that complement our existing offerings, and further penetrate key industries. In Shoppers, we also are pursuing strategic initiatives, ranging from increased penetration in travel and entertainment ad budgets to new packaging for Hispanic markets. We also have stepped up our commitment to expand circulation in South Florida, Southern California and, particularly, Northern California.

Our board, officers and unit managers understand our unquestioned commitment to financial integrity and our continued vigorous pursuit of it.

Also on the financial front, Harte-Hanks fully complies with the requirements of the recently implemented Sarbanes-Oxley Act, including the new financial statement certification requirements. Our board, officers and unit managers understand our unquestioned commitment to financial integrity and our continued vigorous pursuit of it.

In May 2002, Harte-Hanks completed a three-for-two split of its common stock. This was the third time Harte-Hanks split its common stock since going public in 1993 for the second time, the other two times being in 1995 and 1998. The company repurchased 5.1 million shares, making a total of 31.6 million shares repurchased since the company first authorized repurchasing in January 1997. At the end of 2002, 2.3 million shares remained under the share repurchase authorization.

In Direct Marketing, Harte-Hanks continues to receive accolades. Both the company and its Trillium Software division were named to the DM Review 100 for the second straight year. Trillium Software in particular was named as a business intelligence "company to watch" by *Intelligent Enterprise* magazine. Harte-Hanks also debuted on *Software* magazine's top 500 software vendor listing because of our proprietary offerings in M/CIS, Trillium Software, and other software solutions.

Several Web sites we created for pharmaceutical and healthcare clients earned top awards again in 2002. *DM Review* cited two more clients, Boise Office Solutions and Fifth Third Bank, for implementing "World-Class Solutions" using Harte-Hanks software. At the National Postal Forum in September, Harte-Hanks team members received two awards for their contributions to the direct mail community and to more efficient postal operations.

Our stable of partners expanded with the announcement of Allink Transact and Allink Innovator solutions, based on strategic relationships forged with Cognos, Inc. and Unica Corporation, respectively. Our new Harte-Hanks e.Vantage solution incorporates E.piphany's E.6 software. In addition, we launched Harte-Hanks M/CIS, the latest generation of our leading proprietary database technology for multichannel applications.

In an environment where thinking differently about the way we do business is critical to our future success, we placed even more emphasis on establishing internal benchmarks and measurements. We have achieved this successfully in Shoppers, and we're expanding

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our focus to include all of our Direct Marketing fulfillment centers.

Harte-Hanks also named new resellers for the Trillium Software System in Australia, New Zealand, China, Taiwan, Malaysia, Brunei, South Korea and Germany, capitalizing on marketplace and information technology expertise in these countries. We opened a new call/contact center in São Paulo, Brazil. A new partner, Ambergris, is providing call center services for us in the Philippines. And our company is now self-certified with the U.S. Department of Commerce for the European Union Data Protection Directive "Safe Harbor," which enables our company, on behalf of our clients, to process data on European consumer and business individuals in our U.S. data centers.

In Shoppers, we increased household circulation in California by 230,000 households, bringing the total number of households in the state receiving *PennySaver* to 8.8 million. In preparation for expansion in Northern California, we invested in increasing readership of that product and succeeded—increasing page count by more than 19% per weekly issue.

During the year, our company named three new company officers: Michael Paulsin, Loren Dalton and Carlos Guzman—all veterans on our Shoppers team. Each is a corporate Vice President, and continues his full-time role with the company. In April, I assumed responsibilities as Chief Executive Officer as well as President, while Larry Franklin continues as Chairman.

During 2002, Harte-Hanks also engaged in a significant effort to harmonize and consolidate its medical, life and disability insurance offerings for its U.S. employees, who were previously covered by a mix of site-specific and company-wide plans. These changes provide more choices to individual employees for their coverage, while providing more control over cost increases in the future.

As we look to 2003, we know our strengths well, and we will capitalize on them. From our market knowledge in retail, high tech and telecommunications, financial services and insurance, and pharmaceuticals and healthcare, to our expanding expertise in automotive, travel and leisure, and other select markets, our delivery of client-driven targeted marketing and media solutions remains very real. In Shoppers we are setting the stage for significant circulation growth. Our clients know we are a good partner. They know we are investing in their future as we invest in ours. Most importantly, they know they can trust our people. These relationships are what makes Harte-Hanks a special company. We continue to "make it happen" for all our constituents and stakeholders.

Real vertical market expertise

In addition to our general expertise in direct marketing and shoppers, Harte-Hanks focuses on important specific business sectors. To cover the almost limitless intricacies of individual vertical markets, we've assembled teams of specialists who know each sector's trends and breathe its climate. These professionals have deep and broad experience in the regulations, guidelines and industry standards that govern these vertical markets, in addition to expertise in marketing strategies. So they excel at creating not just short-term solutions for our clients but long-term solutions too.

Our clients in Shoppers and Direct Marketing depend on the understanding and insight Harte-Hanks brings to all media—whether the subject is new telemarketing regulations or changes in U.S. Postal Service requirements. In addition, we maintain a corporate-level Privacy and Compliance Committee to facilitate adherence to privacy laws across all client services. One of its most important functions is helping our vertical market experts keep clients informed of critical privacy-related news.

We also stay aware of changes in each vertical market so that we can anticipate issues for our clients and find solutions ahead of the curve. Because the reality is that the marketplace is becoming tougher and tougher. For companies to compete and win—even to survive—they must keep getting more and more efficient at winning customers, turning them into best customers, and keeping them.

Harte-Hanks is committed to offering clients the best resources to compete and win in this challenging environment. In 2002, we invested in several significant strategic initiatives to strengthen our position for the long run. These investments are all about meeting customer needs—the focus that's essential to the market leadership necessary to drive revenue throughout this decade.

REAL MISSION

Harte-Hanks has a clearly stated mission that guides management's targeting of the company's resources and energy: *to be a customer focused, high performance growth company*.

Customer focus is where it starts. We listen to and hear our clients, and we set goals to exceed their expectations. Just one example of the emphasis Harte-Hanks places on customer focus is our strategic account management program. In Direct Marketing, we provide a team specifically dedicated to managing every aspect of our client relationship. Each team coordinates resources across our solution points, from database construction to program execution.

High performance means doing things right at the lowest possible price. Our benchmarking in Shoppers provides a great example of how we continuously improve productivity—year after year, improving efficiency as measured by a number of production metrics. High performance, however, also means building client trust by delivering tangible benefits.

Growth is certainly difficult to achieve in this environment. We managed, however, to increase earnings per share in 2002. We are not pleased with our results on an absolute level, but are pleased with our performance in the context of the challenges presented by the 2002 business climate.

What makes achieving this mission possible is the caliber of the people who live it every day. Whether we're toughing it out in a difficult economy or making the most of our opportunities in better conditions, the people of Harte-Hanks—bottom to top—share a passion. Our common passion is a commitment to winning—winning in the short run, winning in the long run, winning fairly, and winning for our clients.

Real financial strength

Harte-Hanks has real financial strength: we are profitable, with earnings per share in 2002 exceeding those in 2001; we generate significant amounts of free cash flow; we have a debt-free balance sheet.

Total financial integrity and honest, transparent reporting of *actual* results have long been trademarks of Harte-Hanks. In these times when the failure of some to follow these principles has damaged the public's trust in corporate America, we have redoubled our commitment to apply our financial principles and maintain our financial integrity.

2002 presented extraordinary challenges. The people of Harte-Hanks met these challenges with determination and courage. Throughout the world every day, in our data centers, cubicles, conference rooms, warehouses, executive offices, loading docks, at client sites and on airplanes, we all rolled up our sleeves and faced the day's work with passion and intensity. This is our report of the results.

Financial contents

Management's discussion and analysis 12 | Consolidated balance sheets 18

Consolidated statements of operations 19 | Consolidated statements of cash flows 20

Consolidated statements of stockholders' equity and comprehensive income 21

Notes to consolidated financial statements 22 | Five-year financial summary 31

Independent auditors' report 32 | Corporate information 32

Directors, officers and Harte-Hanks operations 33

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

Overview

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 a worldwide direct and targeted marketing company that provides direct marketing services and shopper advertising opportunities to a wide range of local, regional, national and international consumer and business-to-business marketers. Harte-Hanks Direct Marketing improves the return on its clients' marketing investment with a range of services organized around five solution points: Construct and update the database → Access the data → Analyze the data → Apply the knowledge → Execute the programs. Harte-Hanks Shoppers is North America's largest owner, operator and distributor of shopper publications, with shoppers that are zoned into more than 800 separate editions reaching more than 10 million households in California and Florida 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. In addition, the Company has used its excess cash flows and borrowings against its credit facilities to fund several acquisitions in the past few years. These acquisitions, as well as several previous acquisitions, have enhanced the Company's growth over the past three years. Harte-Hanks has funded $75.9 million in acquisitions during the period 2000 through 2002. These acquisitions have all been in the Company's Direct Marketing segment, which comprises approximately 63% of the Company's revenues for the year ended December 31, 2002.

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

Results of Operations

Effective January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets," under which goodwill is no longer amortized for book purposes (See Note A of the "Notes to Consolidated Financial Statements," included herein). For the purposes of the Management's Discussion and Analysis section of this report, all prior year numbers have been restated as if SFAS No. 142 had been adopted for the year.

Operating results were as follows:

In thousands	2002	% Change	2001[1]	% Change	2000[1]
Revenue	$ 908,777	-1.0	$ 917,928	-4.5	$ 960,773
Operating expenses	758,489	-0.5	762,075	-5.7	807,759
Operating income	$ 150,288	-3.6	$ 155,853	1.9	$ 153,014

1 Results as if SFAS 142 had been adopted for the period. Reported results for the years ended December 31, 2001, and 2000, including goodwill amortization, were operating expenses of $778,298 and $822,552 respectively, and operating income of $139,630 and $138,221 respectively.

Consolidated revenues declined 1.0% to $908.8 million while operating income declined 3.6% to $150.3 million in 2002 compared to 2001. Overall operating expenses decreased 0.5% to $758.5 million. The Company's overall results reflect revenue and operating income declines in its Direct Marketing segment, partially offset by increased revenue and operating income in the Shopper segment.

The Company's overall 2001 results reflect revenue declines in its Direct Marketing segment, partially offset by increased revenues from the Shoppers segment. Overall 2001 operating income results reflect increased operating income from the Shoppers segment, partially offset by operating income declines from its Direct Marketing segment.

Direct Marketing

Direct Marketing operating results were as follows:

In thousands	2002	% Change	2001[1]	% Change	2000[1]
Revenue	$ 573,826	-4.7	$ 601,901	-9.1	$ 662,044
Operating expenses	489,954	-2.9	504,730	-9.8	559,872
Operating income	$ 83,872	-13.7	$ 97,171	-4.9	$ 102,172

1 Results as if SFAS 142 had been adopted for the period. Reported results for the years ended December 31, 2001, and 2000, including goodwill amortization, were operating expenses of $516,881 and $570,594 respectively, and operating income of $85,020 and $91,450 respectively.

Direct Marketing revenues decreased $28.1 million, or 4.7%, in 2002 compared to 2001. These results reflect revenue declines in most of the company's largest vertical markets, including financial services, retail and pharmaceutical/healthcare. Revenues from the high-tech/telecom industry sector were flat compared to 2001. The segment's select markets group had increased revenue, primarily from the automotive and energy sectors, that were largely attributable to the November 2001 acquisition of Sales Support Services, Inc. Direct Marketing experienced revenue declines in data sales, data processing, Internet services, consulting services, personalized direct mail and targeted mail businesses partially offset by increased revenues from software sales, logistics operations and agency-type business. Direct Marketing revenues were also affected by the 2001 acquisition noted above.

Operating expenses decreased $14.8 million, or 2.9%, in 2002 compared to 2001. Labor costs decreased $19.0 million due to lower volumes and staff reductions. Production and distribution costs increased $6.7 million, primarily due to higher transportation costs related to higher logistics revenues and higher temporary labor costs. General and administrative expenses decreased $2.8 million due to a decrease in bad debt expense, professional services and business services. Depreciation expense increased $0.3 million due to new capital investments to support future growth and improve efficiencies. Operating expenses were also impacted by the 2001 acquisition noted above.

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

Operating expenses decreased $55.1 million, or 9.8%, in 2001 compared to 2000. The overall decrease in operating expenses was primarily due to the Company's efforts to manage its cost structure in a difficult economic environment, as well as reduced

variable expenses resulting from lower revenue levels. Labor costs declined $16.2 million due to lower volumes and staff reductions. Production and distribution costs decreased $28.4 million due primarily to decreased volumes and better pricing obtained from vendors. General and administrative expenses decreased $14.4 million due to decreases in employee expense and professional services. Depreciation expense increased $3.7 million due to new capital investments to support future growth and improve efficiencies. Operating expenses were also impacted by 2001 and 2000 acquisitions.

Shoppers

Shopper operating results were as follows:

In thousands	2002	% Change	2001[1]	% Change	2000[1]
Revenue	$ 334,951	6.0	$ 316,027	5.8	$ 298,729
Operating expenses	260,387	4.8	248,557	4.0	238,948
Operating income	$ 74,564	10.5	$ 67,470	12.9	$ 59,781

1 Results as if SFAS 142 had been adopted for the period. Reported results for the years ended December 31, 2001, and 2000, including goodwill amortization, were operating expenses of $252,629 and $243,019 respectively, and operating income of $63,398 and $55,710 respectively.

Shopper revenues increased $18.9 million, or 6.0%, in 2002 compared to 2001. Revenue increases were the result of improved sales in established markets as well as geographic expansions into new neighborhoods in California. From a product-line perspective, Shoppers had growth in both run-of-press (ROP, or in-book) advertising, primarily real estate-related advertising, and its distribution products, primarily four-color glossy flyers. These increases were partially offset by declines in employment-related ROP advertising and coupon book revenues.

Shopper operating expenses rose $11.8 million, or 4.8%, in 2002 compared to 2001. Labor costs increased $7.5 million due to higher volumes. Production costs increased $4.5 million due to a $5.0 million increase in postage resulting from higher postage rates and increased circulation and volumes. Partially offsetting these increased postage costs were decreased paper costs due to lower rates for both newsprint and job paper. General and administrative costs were flat, as decreased bad debt expense was offset by higher promotion and facilities expenses.

Shopper revenues increased $17.3 million, or 5.8%, in 2001 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, revenue increased due to growth in distribution products and ROP, primarily core sales and real estate-related advertising. These increases were partially offset by declines in employment-related ROP 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.

Acquisitions

As described in Note B of the "Notes to Consolidated Financial Statements" included herein, the Company made three 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 serving the automotive, energy and other industries.

The Company acquired the 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 high-tech, telecommunications and financial services industries, in June 2000.

Interest Expense/Interest Income

Interest expense decreased $1.9 million in 2002 over 2001 due primarily to lower outstanding debt levels of the Company's revolving credit facilities. The decrease in interest expense in 2002 was also a result of lower rates in 2002 compared to 2001. 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 2001. The increase in interest expense in 2001 attributable to the higher debt levels was partially offset by lower interest rates in 2001 compared to 2000. The Company's debt on December 31, 2002,

and 2001 is described in Note D of the "Notes to Consolidated Financial Statements," included herein.

Interest income decreased $0.2 million in 2002 compared to 2001 due to lower interest rates in 2002 compared to 2001. Interest income decreased $1.6 million in 2001 over 2000 due to lower interest rates and lower average cash balances during the year.

Other Income and Expense

Other net expense for 2002 primarily consists of balance-based bank charges and stockholders expenses. During 2001 the Company realized $2.5 million in losses on the sales of investments that were classified as available for sale and $0.9 million in losses on the sales of investments that were accounted for under the cost method. The remaining other net expense for 2001 primarily consists of balance-based bank charges and stockholders expenses.

Income Taxes

Income taxes decreased $0.4 million in 2002 and $2.1 million in 2001 due to lower income levels. The effective income tax rates were 38.4%, 38.3%, and 38.9% in 2002, 2001 and 2000, respectively. The effective income tax rate calculated is higher than the federal statutory rate of 35% due to the addition of state taxes.

Capital Investments

Net cash used in investing activities for 2002 included $17.4 million for capital expenditures and $3.8 million for acquisition-related payments. The capital expenditures consisted primarily of additional computer capacity, technology, systems, new press equipment and equipment upgrades for the Direct Marketing segment. The Shopper segment's capital expenditures were primarily related to additional computer and other production equipment. The acquisition-related payments, which all relate to prior years' acquisitions, were made in the Direct Marketing segment and are discussed above in the section titled "Acquisitions."

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 Marketing segment, are discussed above in the section titled "Acquisitions." The capital expenditures consisted primarily of additional computer capacity, technology, systems, new press equipment and equipment upgrades for the Direct Marketing segment. The Company also invested in facility expansion in its Direct Marketing segment. The Shopper segment's capital expenditures were primarily related to facility improvements and additional computer and other production equipment.

Critical Accounting Policies

Financial Reporting Release No. 60, 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 Marketing revenue is derived from a variety of services. Revenue from services such as creative and graphics, printing, personalization of communication pieces using laser and inkjet printing, targeted 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.

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, software licenses with 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 equal 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.

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 $1.2 million, $4.4 million and $4.6 million for the years ended December 31, 2002, 2001, and 2000, respectively.

Reserve for Workers' Compensation, Automobile and General Liability

The Company has a $250,000 deductible for automobile and general liability. The Company's deductible for workers' compensation increased from $250,000 to $1.0 million in October 2002. 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 open 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 its experience dealing with similar types of 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 to the extent that the purchase price exceeds the fair value of the assets acquired in accordance with Statement of Financial Accounting Standards ("SFAS") No. 142. Prior to the adoption of SFAS No. 142 on January 1, 2002, goodwill was being amortized on a straight-line basis over 15 to 40 year periods. Beginning January 1, 2002, goodwill is no longer being amortized, but instead is tested for impairment as discussed below.

The Company assesses the impairment of its goodwill in accordance with SFAS No. 142, by determining the fair value of each of its reporting units and comparing the fair value to the carrying value for each reporting unit. The Company has identified its reporting units as Customer Relationship Management (CRM), Marketing Services and Shoppers. Fair value is determined using projected discounted future cash flows and cash flow multiple models, based on historical performance and management's estimate of future performance, giving consideration to existing and anticipated competitive and economic conditions. If a reporting unit's carrying amount exceeds its fair value, the Company must calculate the implied fair value of the reporting unit's goodwill 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, and then compare this implied fair value to its carrying amount. To the extent that the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recorded. The Company has not recorded an impairment loss in any of the three years ended December 31, 2002.

At December 31, 2002, and 2001, the Company's goodwill balance was $436.8 million, net of $82.0 million of accumulated amortization, and $434.5 million, net of $82.0 million of accumulated amortization, respectively. Amortization expense related to goodwill was $16.2 million and $14.8 million for the years ended December 31, 2001, and 2000, respectively.

Liquidity and Capital Resources

Cash provided by operating activities for 2002 was $141.6 million, down $11.3 million compared to 2001. The decrease in 2002 primarily relates to collections of a lower accounts receivable balance at December 31, 2001, than at December 31, 2000, due to decreased revenues. Net cash outflows from investing activities were $20.7 million for 2002 compared to net cash outflows of $53.4 in 2001. The decrease in 2002 primarily relates to less cash spent on acquisitions and lower capital investments in 2002 than 2001. Net cash outflows from financing activities in 2002 were $126.4 million compared to $92.0 million in 2001. The increase in 2002 primarily relates to higher net repayments of debt and a higher overall amount spent repurchasing stock in 2002 than 2001.

Capital resources are available from, and provided through, the Company's unsecured credit facility. This credit facility, a three-year $125-million variable-rate revolving loan commitment, was put in place on October 18, 2002. All borrowings under this credit agreement are to be repaid by October 17, 2005.

Management believes that its credit facility, 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, 2002, the Company had $110.0 million of unused borrowing capacity under its credit facility.

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 which could affect the Company's future performance, including its revenues, net income and earnings per share; however, the risks described below 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 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 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 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 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 Marketing business faces competition in all of its offerings. 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, shopper publications 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 to continually 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 from time to time and in the foreseeable future will likely remain a limited resource.

Postal Rates—The Company's shopper publications and direct marketing services depend on the United States Postal Service 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. Standard postage rates increased at the beginning of the third quarter of 2002. 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 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. In recent years newsprint prices have fluctuated widely, and such fluctuations can materially affect the results of the Company's operations.

Economic Conditions—Changes in national economic conditions 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 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 $125 million credit facility. The Company also has exposure to interest rate fluctuations in the United States, specifically money market, commercial paper and overnight time deposit rates as these affect the Company's earnings on its excess cash.

War—War or the threat of war involving the United States could have a significant impact on the Company's operations. War could substantially affect the levels of advertising expenditures by clients in each of the Company's businesses. In addition, each of the Company's businesses could be affected by operational disruptions and a shortage of supplies and labor related to such a war.

Harte-Hanks, Inc. and Subsidiaries Consolidated Balance Sheets

In thousands, except per share and share amounts	December 31, 2002	December 31, 2001
ASSETS		
Current assets		
Cash and cash equivalents	**$ 25,026**	$ 30,468
Accounts receivable (*less allowance for doubtful accounts of $3,025 in 2002 and $5,463 in 2001*)	**137,679**	138,409
Inventory	**5,299**	5,835
Prepaid expenses	**14,070**	13,411
Current deferred income tax asset	**8,129**	8,378
Other current assets	**8,409**	6,306
Total current assets	**198,612**	202,807
Property, plant and equipment		
Land	**3,335**	3,325
Buildings and improvements	**32,442**	31,045
Software	**53,279**	45,806
Equipment and furniture	**178,684**	178,842
	267,740	259,018
Less accumulated depreciation and amortization	**(179,741)**	(152,558)
	87,999	106,460
Software development and equipment installations in progress	**6,155**	2,968
Net property, plant and equipment	**94,154**	109,428
Intangible and other assets		
Goodwill (*less accumulated amortization of $81,965 in 2002 and 2001*)	**436,800**	434,458
Other intangible assets (*less accumulated amortization of $1,733 in 2002 and $1,133 in 2001*)	**3,267**	3,867
Other assets	**3,899**	20,489
Total intangible and other assets	**443,966**	458,814
Total assets	**$736,732**	$ 771,049
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	**$ 40,746**	$ 42,990
Accrued payroll and related expenses	**21,854**	21,550
Customer deposits and unearned revenue	**41,775**	38,617
Income taxes payable	**9,338**	10,531
Other current liabilities	**8,048**	8,086
Total current liabilities	**121,761**	121,774
Long-term debt	**16,300**	48,312
Other long-term liabilities (*including deferred income taxes of $21,602 in 2002 and $29,515 in 2001*)	**66,138**	48,597
Total liabilities	**204,199**	218,683
Stockholders' equity		
Common stock, $1 par value, authorized 375,000,000 shares Issued 2002: 111,534,630; 2001: 109,352,290 shares	**111,535**	109,352
Additional paid-in capital	**216,149**	188,158
Retained earnings	**722,231**	640,635
Less treasury stock, 2002: 21,329,896; 2001: 16,139,795 shares at cost	**(491,793)**	(384,486)
Accumulated other comprehensive loss	**(25,589)**	(1,293)
Total stockholders' equity	**532,533**	552,366
Total liabilities and stockholders' equity	**$736,732**	$ 771,049

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	**2002**	2001	2000
Revenue	**$ 908,777**	$ 917,928	$ 960,773
Operating expenses			
Payroll	**324,733**	335,913	350,058
Production and distribution	**324,806**	313,639	336,444
Advertising, selling, general and administrative	**76,222**	79,826	92,330
Depreciation	**32,128**	32,079	28,494
Goodwill and intangible amortization	**600**	16,841	15,226
Total operating expenses	**758,489**	778,298	822,552
Operating income	**150,288**	139,630	138,221
Other expenses (income)			
Interest expense	**1,208**	3,076	1,678
Interest income	**(274)**	(498)	(2,062)
Other, net	**2,004**	4,614	1,746
	2,938	7,192	1,362
Income before income taxes	**147,350**	132,438	136,859
Income tax expense	**56,605**	52,754	54,973
Net income	**$ 90,745**	$ 79,684	$ 81,886
Basic earnings per common share	**$ 0.98**	$ 0.84	$ 0.81
Weighted-average common shares outstanding	**92,648**	94,808	101,276
Diluted earnings per common share	**$ 0.96**	$ 0.82	$ 0.78
Weighted-average common and common equivalent shares outstanding	**94,872**	97,174	104,480

A reconciliation of the effects of the adoption of Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," on net income and basic and diluted earnings per share is as follows:

	2002	2001	2000
Net income	**$ 90,745**	$ 79,684	$ 81,886
Add back: Goodwill amortization (net of tax effect)	**—**	12,016	10,752
Adjusted net income	**$ 90,745**	$ 91,700	$ 92,638
Basic earnings per common share:			
Net income	**$ 0.98**	$ 0.84	$ 0.81
Add back: Goodwill amortization (net of tax effect)	**—**	0.13	0.10
Adjusted net income	**$ 0.98**	$ 0.97	$ 0.91
Diluted earnings per common share:			
Net income	**$ 0.96**	$ 0.82	$ 0.78
Add back: Goodwill amortization (net of tax effect)	**—**	0.12	0.11
Adjusted net income	**$ 0.96**	$ 0.94	$ 0.89

SFAS No. 142 is described in Note A of the Notes to Consolidated Financial Statements.

See Notes to Consolidated Financial Statements

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

In thousands	Year Ended December 31, 2002	2001	2000
Cash Flows from Operating Activities			
Net income	**$ 90,745**	$ 79,684	$ 81,886
Adjustments to reconcile net income to net cash provided by operations:			
Depreciation	**32,128**	32,079	28,494
Goodwill and intangible amortization	**600**	16,841	15,226
Amortization of option-related compensation	**99**	206	441
Deferred income taxes	**8,878**	2,470	5,942
Other, net	**741**	4,464	424
Changes in operating assets and liabilities, net of effects from acquisitions and divestitures:			
(Increase) decrease in accounts receivable, net	**730**	47,578	(22,514)
Decrease in inventory	**536**	425	839
Increase in prepaid expenses and other current assets	**(2,762)**	(124)	(1,848)
Increase (decrease) in accounts payable	**(2,244)**	(17,054)	1,451
Increase (decrease) in other accrued expenses and other liabilities	**8,884**	(12,350)	5,095
Other, net	**3,302**	(1,278)	(4,511)
Net cash provided by operating activities	**141,637**	152,941	110,925
Cash Flows from Investing Activities			
Acquisitions	**(3,791)**	(28,230)	(43,873)
Purchases of property, plant and equipment	**(17,358)**	(26,445)	(36,465)
Proceeds from the sale of property, plant and equipment	**439**	492	432
Other investing activities	**—**	801	391
Net cash used in investing activities	**(20,710)**	(53,382)	(79,515)
Cash Flows from Financing Activities			
Long-term borrowings	**34,000**	282,000	58,494
Payments on debt	**(66,531)**	(292,000)	(5,000)
Issuance of common stock	**14,113**	9,131	6,506
Issuance of treasury stock	**110**	75	81
Purchase of treasury stock	**(98,912)**	(83,664)	(92,706)
Warrants repurchased	**—**	—	(4,317)
Dividends paid	**(9,149)**	(7,561)	(6,736)
Net cash used in financing activities	**(126,369)**	(92,019)	(43,678)
Net increase (decrease) in cash and cash equivalents	**(5,442)**	7,540	(12,268)
Cash and cash equivalents at beginning of year	**30,468**	22,928	35,196
Cash and cash equivalents at end of year	**$ 25,026**	$ 30,468	$ 22,928
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	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at January 1, 2000	$ 110,445	$ 163,401	$ 493,362	$ (201,906)	$ 12,316	$ 577,618
Common stock issued — employee benefit plans	294	3,711	—	—	—	4,005
Exercise of stock options for cash and by surrender of shares	492	2,009	—	—	—	2,501
Tax benefit of options exercised	—	1,581	—	—	—	1,581
Dividends paid ($0.067 per share)	—	—	(6,736)	—	—	(6,736)
Treasury stock issued	—	11	—	70	—	81
Treasury stock repurchased	(1,972)	1,972	—	(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	109,259	169,879	568,512	(294,542)	(2,105)	551,003
Common stock issued — employee benefit plans	266	3,186	—	—	—	3,452
Exercise of stock options for cash and by surrender of shares	1,782	6,717	—	(6,350)	—	2,149
Tax benefit of options exercised	—	6,416	—	—	—	6,416
Dividends paid ($0.08 per share)	—	—	(7,561)	—	—	(7,561)
Treasury stock issued	—	5	—	70	—	75
Treasury stock repurchased	(1,955)	1,955	—	(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	109,352	188,158	640,635	(384,486)	(1,293)	552,366
Common stock issued — employee benefit plans	**202**	**3,131**	**—**	**—**	**—**	**3,333**
Exercise of stock options for cash and by surrender of shares	**2,282**	**13,787**	**—**	**(8,498)**	**—**	**7,571**
Tax benefit of options exercised	**—**	**10,765**	**—**	**—**	**—**	**10,765**
Dividends paid ($0.098 per share)	**—**	**—**	**(9,149)**	**—**	**—**	**(9,149)**
Treasury stock issued	**—**	**7**	**—**	**103**	**—**	**110**
Treasury stock repurchased	**(301)**	**301**	**—**	**(98,912)**	**—**	**(98,912)**
Comprehensive income, net of tax:						
Net income	**—**	**—**	**90,745**	**—**	**—**	**90,745**
Adjustment for minimum pension liability (net of tax of $17,121)	**—**	**—**	**—**	**—**	**(26,169)**	**(26,169)**
Foreign currency translation adjustment	**—**	**—**	**—**	**—**	**1,873**	**1,873**
Total comprehensive income						**66,449**
Balance at December 31, 2002	**$ 111,535**	**$216,149**	**$722,231**	**$ (491,793)**	**$(25,589)**	**$ 532,533**

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

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.

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 $1.2 million, $4.4 million and $4.6 million for the years ended December 31, 2002, 2001, and 2000, 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 is recorded to the extent that the purchase price exceeds the fair value of the assets acquired in accordance with Statement of Financial Accounting Standards ("SFAS") No. 142. Prior to the adoption of SFAS No. 142 on January 1, 2002, goodwill was being amortized on a straight-line basis over 15 to 40 year periods. Beginning January 1, 2002, goodwill is no longer being amortized, but instead is tested for impairment as discussed below.

The Company assesses the impairment of its goodwill in accordance with SFAS No. 142, by determining the fair value of each of its reporting units and comparing the fair value to the carrying value for each reporting unit. The Company has identified its reporting units as Customer Relationship Management (CRM), Marketing Services and Shoppers. Fair value is determined using projected discounted future cash flows and cash flow multiple models, based on historical performance and management's estimate of future performance, giving consideration to existing and anticipated competitive and economic conditions. If a reporting unit's carrying amount exceeds its fair value, the Company must calculate the implied fair value of the reporting unit's goodwill 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, and then compare this implied fair value to its carrying amount. To the extent that the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recorded. The Company has not recorded an impairment loss in any of the three years ended December 31, 2002.

At December 31, 2002, and 2001, the Company's goodwill balance was $436.8 million, net of $82.0 million of accumulated amortization, and $434.5 million, net of $82.0 million of accumulated amortization, respectively. Amortization expense related to goodwill was $16.2 million and $14.8 million for the years ended December 31, 2001, and 2000, respectively.

Other intangibles with definite useful lives are recorded on the basis of cost in accordance with SFAS No. 142, and are amortized on a straight-line basis over a period of 5 to 10 years. The Company assesses the recoverability of its other intangibles with definite lives 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, 2002, and 2001, the Company's other intangibles with definite useful lives balance was $3.3 million, net of $1.7 million of accumulated amortization, and $3.9 million, net of $1.1 million of accumulated amortization. Amortization expense related to other intangibles with definite useful lives was $0.6 million, $0.6 million and $0.4 million for the years ended December 31, 2002, 2001, and 2000, respectively. Expected amortization expense is $0.6 million for the years ending December 31, 2003, 2004, and 2005, and $0.4 million for the years ending December 31, 2006 and 2007.

As of December 31, 2002, and 2001, the Company does not have any intangibles with indefinite useful lives other than goodwill.

Income Taxes

Income taxes are calculated using the asset and liability method required by 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.

Stock-based Compensation

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,* 2002	2001	2000
Net income—as reported	**$ 90,745**	$ 79,684	$ 81,886
Stock-based employee compensation expense, included in reported net income, net of related tax effects	**61**	124	264
Stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	**(4,411)**	(4,362)	(4,905)
Net income—pro forma	**$ 86,395**	$ 75,446	$ 77,245
Basic earnings per share—as reported	**$ 0.98**	$ 0.84	$ 0.81
Basic earnings per share—pro forma	**$ 0.93**	$ 0.80	$ 0.76
Diluted earnings per share—as reported	**$ 0.96**	$ 0.82	$ 0.78
Diluted earnings per share—pro forma	**$ 0.91**	$ 0.78	$ 0.74

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 2002, 2001 and 2000:

	Year Ended December 31, 2002	2001	2000
Expected dividend yield	**0.5%**	0.5%	0.4%
Expected stock price volatility	**27.8%**	21.0%	23.0%
Risk-free interest rate	**5.4%**	5.7%	5.9%
Expected life of options	**3-10 years**	3-10 years	3-10 years

Stock Split

In May 2002, the Company effected a three-for-two stock split in the form of a 50% stock dividend payable to holders of record on May 20, 2002. All share, per share and common stock information in the Consolidated Financial Statements and the Notes thereto has been restated to retroactively reflect the stock split.

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.

Direct 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, 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. 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 automobile and general liability. The Company's deductible for workers' compensation increased from $250,000 to $1.0 million in October 2002. 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 open 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 its experience dealing with similar types of 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 Pronouncements

SFAS No. 143, "Accounting for Asset Retirement Obligations," issued in June 2001, addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived obligations that result from the acquisition, construction, development and/or normal use of the asset. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The Company will adopt SFAS No. 143 as of January 1, 2003. At this time the Company does not believe that the adoption of SFAS No. 143 will have a material impact on its financial statements.

SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," issued in July 2002, addresses financial accounting and reporting for costs associated with exit or disposal activities. SFAS No. 146 requires that a liability be recognized for those costs only when the liability is incurred and can be measured at fair value. This statement nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity," which required liability recognition for an exit cost when a company committed to an exit plan. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The Company will adopt SFAS No. 146 as of January 1, 2003. At this time the Company does not believe that the adoption of SFAS No. 146 will have a material impact on its financial statements.

In November 2002, the FASB issued Interpretation No. 45 ("FIN No. 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 requires a company, at the time it issues a guarantee, to recognize an initial liability for the fair value of obligations assumed under the guarantee and elaborates on existing disclosure requirements related to guarantees and warranties. The initial recognition requirements of FIN No. 45 are effective for guarantees issued or modified after December 31, 2002, and adoption of the disclosure requirements are effective for the Company during the first quarter ending after January 31, 2003. The Company does not expect the adoption of FIN No. 45 to have a significant impact on its consolidated financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value-based method of accounting for stock-based employee compensation prescribed by SFAS No. 123. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and annual disclosure provisions of SFAS No. 148 are effective for the fiscal years ending after December 15, 2002, and the annual disclosure provisions are included in the notes to these consolidated financial statements. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The Company does not expect the adoption of SFAS No. 148 to have a significant impact on its consolidated financial position or results of operations.

Note B — Acquisitions

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

The total cash outlay in 2002 for acquisitions was $3.8 million. 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 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 prior years' acquisitions, as they are not considered material to the Company as a whole.

Note C — 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.

The Company sold all of these equity investments in 2001 and 2000 and owns no equity investments at December 31, 2002. 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

Cash payments for interest were $1.3 million, $3.4 million and $1.3 million for the years ended December 31, 2002, 2001, and 2000, respectively.

IN THOUSANDS	December 31, 2002	2001
Revolving loan commitment, various interest rates based on EUROLIBOR (effective rate of 1.93% at December 31, 2002), due October 17, 2005	**$ 15,000**	$ 45,000
Revolving loan commitment, various interest rates based on EURIBOR (effective rate of 3.20% at December 31,2002), due July 20, 2003	**1,300**	3,312
Less current maturities	**—**	—
	$ 16,300	$ 48,312

Credit Facilities

On October 18, 2002 the Company obtained a three-year $125 million variable rate unsecured revolving credit facility. This $125 million facility replaced the Company's two $100 million credit facilities which were terminated on October 18, 2002. All borrowings under this $125 million credit agreement are to be repaid by October 17, 2005. Commitment fees on the total credit facility 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 .125% to .175%. Interest rates on drawn amounts range from EUROLIBOR plus .5% to EUROLIBOR plus .7%. This credit facility contains both affirmative and negative covenants, and the Company has been in compliance with these covenants since obtaining the credit facility. As of December 31, 2002, the Company had $110 million of unused borrowing capacity under this credit agreement.

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 of 2.5 million Euros were repaid on December 16, 2002. All borrowings under the increased amount of 1.2 million Euros 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 31, 2002, the Company had no unused borrowing capacity under this credit facility. It is the Company's intent to repay this note on July 20, 2003, with borrowings under its three-year revolving credit facility.

Note E — Income Taxes

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

IN THOUSANDS	Year Ended December 31, 2002	2001	2000
Current			
Federal	**$ 41,602**	$ 43,010	$ 40,502
State and local	**6,026**	6,776	6,679
Foreign	**99**	498	1,850
Total current	**$ 47,727**	$ 50,284	$ 49,031
Deferred			
Federal	**$ 7,087**	$ 2,716	$ 5,321
State and local	**1,791**	(246)	621
Total deferred	**$ 8,878**	$ 2,470	$ 5,942

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:

IN THOUSANDS	Year Ended December 31, 2002		2001		2000	
Computed expected income tax expense	**$ 51,572**	**35%**	$ 46,353	35%	$ 47,900	35%
Net effect of state income tax	**4,922**	**3%**	4,368	3%	4,857	4%
Effect of goodwill amortization	**—**	**0%**	1,607	1%	1,633	1%
Change in the beginning of the year balance of the valuation allowance	**159**	**0%**	(124)	0%	(112)	0%
Other, net	**(48)**	**0%**	550	0%	695	1%
Income tax expense for the period	**$ 56,605**	**38%**	$ 52,754	40%	$ 54,973	40%

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

IN THOUSANDS	Year Ended December 31, 2002	2001	2000
Results of operations	**$ 56,605**	$ 52,754	$ 54,973
Stockholders' equity	**(27,886)**	(5,935)	(10,207)
Total	**$ 28,719**	$ 46,819	$ 44,766

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

IN THOUSANDS	December 31, 2002	2001
Deferred tax assets:		
Deferred compensation and retirement plans	**$ 16,270**	$ 1,336
Accrued expenses not deductible until paid	**4,204**	4,327
Accounts receivable, net	**978**	1,674
Other, net	**190**	162
State net operating loss carryforwards	**848**	759
Capital loss carryforward	**492**	492
Total gross deferred tax assets	**22,982**	8,750
Less valuation allowance	**(1,277)**	(897)
Net deferred tax assets	**21,705**	7,853
Deferred tax liabilities:		
Property, plant and equipment	**(12,134)**	(12,878)
Goodwill	**(23,404)**	(15,474)
State income tax	**360**	(638)
Total gross deferred tax liabilities	**(35,178)**	(28,990)
Net deferred tax liabilities	**$(13,473)**	$ (21,137)

The valuation allowance for deferred tax assets as of January 1, 2001, was $455,000. The valuation allowance at December 31, 2002, relates to state net operating losses of $784,000 and capital losses of $493,000, which are not expected to be realized. The valuation allowance at December 31, 2001, related to state net operating losses of $405,000 and capital losses of $492,000 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 $37.8 million, $38.0 million and $47.8 million in 2002, 2001 and 2000, 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, 2002	2001
Change in benefit obligation		
Benefit obligation at beginning of year	**$ 85,992**	$ 85,369
Service cost	**581**	543
Interest cost	**6,662**	6,045
Actuarial loss (gain)	**13,435**	(1,512)
Benefits paid	**(4,519)**	(4,453)
Benefit obligation at end of year	**102,151**	85,992
Change in plan assets		
Fair value of plan assets at beginning of year	**79,241**	90,356
Actual return on plan assets	**(10,062)**	(6,662)
Benefits paid	**(4,519)**	(4,453)
Fair value of plan assets at end of year	**64,660**	79,241
Funded status	**(37,491)**	(6,751)
Unrecognized actuarial loss	**47,187**	17,825
Unrecognized prior service cost	**555**	620
Net amount recognized	**$ 10,251**	$ 11,694

The Company's non-qualified pension plan had an accumulated benefit obligation in excess of its assets of $12.2 million at December 31, 2002.

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

	December 31, 2002	2001	2000
Weighted-average assumptions as of December 31			
Discount rate	**6.85%**	7.40%	7.50%
Expected return on plan assets	**9.00%**	9.00%	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, 2002	2001	2000
Components of net periodic benefit cost (income)			
Service cost	$ 581	$ 543	$ 338
Interest cost	6,662	6,045	5,373
Expected return on plan assets	(6,931)	(8,820)	(9,951)
Amortization of prior service cost	65	65	65
Recognized actuarial loss (gain)	1,066	64	(1,575)
Net periodic benefit cost (income)	$ 1,443	$ (2,103)	$ (5,750)

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 2002, 2001 and 2000 was $6.4 million, $6.3 million and $6.2 million, respectively.

The 1994 Employee Stock Purchase Plan provides for a total of 6,000,000 shares to be sold to participating employees at 85% of the fair market value at specified quarterly investment dates. Shares available for sale totaled 3,212,655 at December 31, 2002.

Note G — Stockholders' Equity

In January 2003, the Company announced an increase in the regular quarterly dividend from 2.5 cents per share to 3.0 cents per share, payable March 14, 2003, to holders of record on March 1, 2003.

In May 2002, the Company effected a three-for-two stock split in the form of a 50% stock dividend payable to holders of record on May 20, 2002. All share, per share and common stock information has been restated to retroactively reflect the stock split.

During 2002 the Company repurchased 5.1 million shares of its common stock for $98.9 million under its stock repurchase program. In addition, the Company received 0.4 million shares of its common stock, with an estimated market value of $8.5 million, in exchange for proceeds related to stock option exercises. As of December 31, 2002, the Company has repurchased 31.6 million shares since the beginning of its stock repurchase program in January 1997. During this period the Company has also received 0.9 million shares in exchange for proceeds related to stock option exercises. Under this program, the Company had authorization to repurchase an additional 2.3 million shares at December 31, 2002. In March 2003, the Company announced an increase of 6.0 million shares in its stock repurchase program.

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, 2002, or 2001. At December 31, 2000, options to purchase 189,000 shares 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 issued to officers and key employees options to purchase up to 16,500,000 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, 2002, 2001, and 2000, market price options to purchase 8,659,127 shares, 9,049,781 shares and 9,895,538 shares, respectively, were outstanding with exercise prices ranging from $2.22 to $21.23 per share at December 31, 2002. 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 became 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, 2002, was $13.43 and $9.35, respectively. The weighted-average remaining life for outstanding market price options was 6.37 years.

At December 31, 2002, 2001, and 2000, performance options to purchase 359,625 shares, 751,875 shares and 1,074,900 shares, respectively, were outstanding with exercise prices ranging from $0.22 to $1.33 per share at December 31, 2002. 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 $0.1 million, $0.2 million and $0.4 million was recognized for the performance options for the years ended December 31, 2002, 2001, and 2000, respectively. The weighted-average exercise price for outstanding performance options and exercisable performance options at December 31, 2002, was $0.52 and $0.44, respectively. The weighted-average remaining life for outstanding performance options was 2.95 years. The Company did not grant any performance options during 2002, 2001 or 2000.

The following summarizes all stock option plans activity during 2002, 2001 and 2000:

	Number Of Shares	Weighted Average Option Price
Options outstanding at January 1, 2000	10,325,501	$ 8.02
Granted	1,745,400	14.67
Exercised	(491,988)	4.91
Cancelled	(419,475)	13.47
Options outstanding at December 31, 2000	11,159,438	9.00
Granted	1,231,650	14.81
Exercised	(1,782,432)	4.84
Cancelled	(807,000)	14.19
Options outstanding at December 31, 2001	9,801,656	10.06
Granted	**2,054,825**	**18.88**
Exercised	**(2,282,461)**	**6.17**
Cancelled	**(555,268)**	**12.24**
Options outstanding at December 31, 2002	**9,018,752**	**$ 12.92**
Exercisable at December 31, 2002	**3,904,482**	**$ 8.68**

The following table summarizes information about stock options outstanding at December 31, 2002:

	Outstanding			*Exercisable*	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$0.22-$7.50	1,685,005	2.38	$ 3.99	1,607,755	$ 4.10
$8.54-$13.04	1,744,012	4.53	$10.33	1,486,591	$ 10.03
$13.38-$14.67	2,120,939	7.44	$14.24	328,443	$ 14.07
$14.75-$16.75	1,448,296	7.01	$16.16	481,693	$ 16.13
$18.22-$18.61	1,245,000	9.02	$18.22	—	$ —
$19.85-$21.23	775,500	9.65	$19.94	—	$ —
	9,018,752	6.27	$12.92	3,904,482	$ 8.68

The weighted-average fair value of market price options granted during 2002, 2001 and 2000 was $6.75, $5.35 and $6.44, respectively. The Company did not grant any performance options during 2002, 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.

Note J — Commitments and Contingencies

At December 31, 2002, the Company had outstanding letters of credit in the amount of $8.6 million. These letters of credit exist to support the Company's insurance programs relating to workers' 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 $29.7 million, $28.5 million and $26.3 million for the years ended December 31, 2002, 2001, and 2000, respectively.

The future minimum rental commitments for all non-cancelable operating leases with terms in excess of one year as of December 31, 2002, are as follows:

In thousands	
2003	$ 24,392
2004	18,623
2005	13,214
2006	13,179
2007	6,871
After 2007	18,987
	$ 95,266

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,* 2002	2001	2000
Basic EPS			
Net income	**$ 90,745**	$ 79,684	$ 81,886
Weighted-average common shares outstanding used in earnings	**92,648**	94,808	101,276
Earnings per share	**$ 0.98**	$ 0.84	$ 0.81
Diluted EPS			
Net income	**$ 90,745**	$ 79,684	$ 81,886
Shares used in diluted earnings per share computations	**94,872**	97,174	104,480
Earnings per share	**$ 0.96**	$ 0.82	$ 0.78
Computation of Shares Used in Earnings Per Share Computations			
Average outstanding common shares	**92,648**	94,808	101,276
Average common equivalent shares—dilutive effect of option shares	**2,224**	2,366	3,204
Shares used in diluted earnings per share computations	**94,872**	97,174	104,480

As of December 31, 2002, 2001, and 2000, the Company had approximately 781,000, 546,000 and 1,297,000 antidilutive market price options outstanding, respectively, which have been excluded from the EPS calculations.

Note M — Selected Quarterly Data (Unaudited)

In thousands, except per share amounts	2002 Quarter Ended				2001 Quarter Ended			
	December 31	September 30	June 30	March 31	December 31	September 30	June 30	March 31
Revenues	**$ 239,525**	**$ 226,466**	**$ 227,879**	**$ 214,907**	$ 233,024	$ 224,130	$ 228,654	$ 232,120
Operating income	**40,190**	**36,656**	**39,981**	**33,461**	35,173	36,046	36,559	31,852
Net income	**24,199**	**22,188**	**24,090**	**20,268**	20,572	19,913	20,836	18,363
Basic earnings per share	**$ 0.27**	**$ 0.24**	**$ 0.26**	**$ 0.22**	$ 0.22	$ 0.21	$ 0.22	$ 0.19
Diluted earnings per share	**$ 0.26**	**$ 0.24**	**$ 0.25**	**$ 0.21**	$ 0.21	$ 0.21	$ 0.21	$ 0.18

Note N — Business Segments

Harte-Hanks is a highly focused targeted media company with operations in two segments—Direct Marketing and Shoppers.

The Company's Direct Marketing segment offers a complete range of specialized, coordinated and integrated direct marketing services from a single source. The Company utilizes advanced technologies to enable its customers to identify, reach and influence specific consumers or businesses. The Company's direct 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 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 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 on 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).

Note N — Business Segments (continued)

In thousands	2002	2001	2000
		Year Ended December 31,	
Revenues			
Direct Marketing	**$ 573,826**	$ 601,901	$ 662,044
Shoppers	**334,951**	316,027	298,729
Total revenues	**$ 908,777**	$ 917,928	$ 960,773
Operating income			
Direct Marketing	**$ 83,872**	$ 85,020	$ 91,450
Shoppers	**74,564**	63,398	55,710
Corporate Activities	**(8,148)**	(8,788)	(8,939)
Total operating income	**$ 150,288**	$ 139,630	$ 138,221
Income before income taxes			
Operating income	**$ 150,288**	$ 139,630	$ 138,221
Interest expense	**(1,208)**	(3,076)	(1,678)
Interest income	**274**	498	2,062
Other, net	**(2,004)**	(4,614)	(1,746)
Total income before income taxes	**$ 147,350**	$ 132,438	$ 136,859
Depreciation			
Direct Marketing	**$ 27,088**	$ 26,769	$ 23,022
Shoppers	**5,008**	5,235	5,393
Corporate Activities	**32**	75	79
Total depreciation	**$ 32,128**	$ 32,079	$ 28,494
Goodwill and intangible amortization			
Direct Marketing	**$ 600**	$ 12,769	$ 11,156
Shoppers	**—**	4,072	4,070
Total goodwill and intangible amortization	**$ 600**	$ 16,841	$ 15,226
Capital expenditures			
Direct Marketing	**$ 12,782**	$ 22,354	$ 34,030
Shoppers	**4,548**	4,085	2,408
Corporate Activities	**28**	6	27
Total capital expenditures	**$ 17,358**	$ 26,445	$ 36,465
Total assets			
Direct Marketing	**$ 518,195**	$ 536,270	
Shoppers	**180,109**	179,748	
Corporate Activities	**38,428**	55,031	
Total assets	**$ 736,732**	$ 771,049	

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

In thousands	2002	2001	2000
		Year Ended December 31,	
Revenues[a]			
United States	**$ 870,700**	$ 880,642	$ 917,160
Other countries	**38,077**	37,286	43,613
Total revenues	**$ 908,777**	$ 917,928	$ 960,773
Long-lived net assets[b]			
United States	**$ 86,324**	$ 101,785	
Other countries	**7,830**	7,643	
Total long-lived assets	**$ 94,154**	$ 109,428	

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	2002	2001	2000	1999	1998
Statement of operations data					
Revenues	**$ 908,777**	$ 917,928	$ 960,773	$ 829,752	$ 748,546
Operating expenses					
Payroll, production and distribution	**649,539**	649,552	686,502	606,676	553,529
Advertising, selling, general and administrative	**76,222**	79,826	92,330	70,060	64,082
Depreciation	**32,128**	32,079	28,494	24,126	21,087
Goodwill and intangible amortization	**600**	16,841	15,226	10,662	7,890
Total operating expenses	**758,489**	778,298	822,552	711,524	646,588
Operating income	**150,288**	139,630	138,221	118,228	101,958
Interest expense, net	**934**	2,578	(384)	(5,313)	(13,281)
Net income	**90,745**	79,684	81,886	72,941	68,371[a]
Earnings per common share—diluted	**0.96**	0.82	0.78	0.67	0.60[a]
Cash dividends per common share	**0.10**	0.08	0.07	0.05	0.04
Weighted-average common and common equivalent shares outstanding—diluted	**94,872**	97,174	104,480	108,216	114,086
Adjusted data to exclude amortization of goodwill, net of tax effect[b]					
Net income	**90,745**	91,700	92,638	80,707	74,964
Earnings per common share—diluted	**0.96**	0.94	0.89	0.75	0.65
Segment data					
Revenues					
Direct Marketing	**$ 573,826**	$ 601,901	$ 662,044	$ 559,262	$ 493,898
Shoppers	**334,951**	316,027	298,729	270,490	254,648
Total revenues	**$ 908,777**	$ 917,928	$ 960,773	$ 829,752	$ 748,546
Operating income					
Direct Marketing	**$ 83,872**	$ 85,020	$ 91,450	$ 79,164	$ 69,648
Shoppers	**74,564**	63,398	55,710	47,015	40,507
General corporate	**(8,148)**	(8,788)	(8,939)	(7,951)	(8,197)
Total operating income	**$ 150,288**	$ 139,630	$ 138,221	$ 118,228	$ 101,958
Operating income excluding amortization of goodwill[b]					
Direct Marketing	**$ 83,872**	$ 97,171	$ 102,172	$ 85,657	$ 73,351
Shoppers	**74,564**	67,470	59,781	51,084	44,694
General corporate	**(8,148)**	(8,788)	(8,939)	(7,951)	(8,197)
Total operating income	**$ 150,288**	$ 155,853	$ 153,014	$ 128,790	$ 109,848
Other data					
Operating cash flow[c]	**$ 183,016**	$ 188,550	$ 181,941	$ 153,016	$ 130,935
Capital expenditures	**17,358**	26,445	36,465	28,928	24,443
Balance sheet data (at end of period)					
Property, plant and equipment, net	**$ 94,154**	$ 109,428	$ 112,065	$ 106,250	$ 92,274
Goodwill and other intangibles, net	**440,067**	438,325	439,148	409,791	290,831
Total assets	**736,732**	771,049	807,105	769,427	715,213
Total long term debt	**16,300**	48,312	65,370	5,000	—
Total stockholders' equity	**532,533**	552,366	551,003	577,618	577,091

a Includes non-recurring pension gain of $1.3 million, or one cent per share, net of $0.8 million income tax expense. Excluding this gain, earnings were $0.59 per share.

b Effective January 1, 2002, the Company adopted the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets," which established new accounting and reporting requirements for goodwill and other intangible assets and eliminated the amortization of goodwill. See Note A for further discussion of SFAS No. 142.

c 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, 2002, and 2001, 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, 2002. 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, 2002, and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note A to the Consolidated Financial Statements, the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" as of January 1, 2002.

KPMG LLP

San Antonio, Texas

January 29, 2003

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 2002 and 2001 were as follows:

	2002		2001	
	High	Low	High	Low
First quarter	21.13	17.64	16.06	14.19
Second quarter	22.68	19.29	17.25	14.24
Third quarter	21.43	16.05	16.60	13.67
Fourth quarter	20.38	17.45	19.28	13.63

In the first quarter of 2002, dividends were paid at the rate of 2.3 cents per share. In the second, third and fourth quarters of 2002, quarterly dividends were paid at the rate of 2.5 cents per share. In 2001, quarterly dividends were paid at the rate of 2.0 cents per share.

There are approximately 2,800 holders of record.

Transfer Agent and Registrar
EquiServe Trust Company, N.A.
PO Box 43010
Providence, RI 02940-3010
(781) 575-3400
www.equiserve.com

Annual Meeting of Stockholders
The annual meeting of stockholders will be held at 10:00 a.m. on May 6, 2003, 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

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

CHRISTOPHER M. HARTE
Private Investor

HOUSTON H. HARTE
Vice Chairman

RICHARD HOCHHAUSER
President and Chief Executive Officer

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

Officers

RICHARD HOCHHAUSER
President and Chief Executive Officer

CRAIG COMBEST
Senior Vice President, Direct Marketing

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, and Secretary

KATHY CALTA
Vice President, Direct Marketing

BILL CARMAN
Vice President, Shoppers

LOREN DALTON
Vice President, Shoppers

JAMES DAVIS
Vice President, Direct Marketing

BILL GOLDBERG
Vice President, Direct Marketing

CARLOS GUZMAN
Vice President, Shoppers

SPENCER JOYNER, JR.
Vice President, Direct Marketing

FEDERICO ORTIZ
Vice President, Tax

MICHAEL PAULSIN
Vice President, Shoppers

TANN TUELLER
Vice President, Direct Marketing

JESSICA HUFF
Controller and Chief Accounting Officer

Corporate Office • San Antonio, Texas *http://www.harte-hanks.com*

DIRECT MARKETING

Austin, Texas
Baltimore, Maryland
Bellmawr, New Jersey
Billerica, Massachusetts
Bloomfield, Connecticut
Cincinnati, Ohio
Clearwater, Florida
Dallas/Grand Prairie, Texas
Deerfield Beach, Florida
Fort Worth, Texas
Forty Fort, Pennsylvania
Fullerton, California
Glen Burnie, Maryland
Jacksonville, Florida
La Jolla, California
Lake Katrine, New York
Lake Mary, Florida
Langhorne, Pennsylvania
Memphis, Tennessee
Monroe Township, New Jersey
New York, New York
Ontario, California
River Edge, New Jersey
San Diego, California
Shawnee, Kansas
Sterling Heights, Michigan
Valencia, California
Vineland, New Jersey
West Bridgewater, Massachusetts
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
Sèvres, France
Uxbridge, United Kingdom

SHOPPERS

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

We make it happen.

P. O. Box 269

San Antonio, TX 78291-0269

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