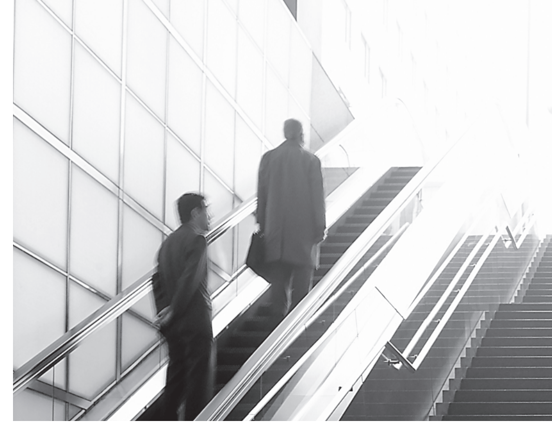
# on the move for our customers

HARTE-HANKS, INC. ANNUAL REPORT | 2003



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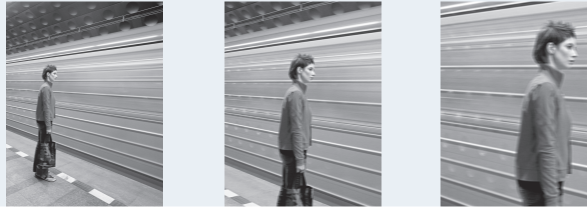
For Harte-Hanks — on the move for our customers — is not just a phrase, it’s a mantra. Not just a goal, it’s a way of doing business. How? By developing and applying unique database technologies, analytic tools, award-winning software, relationship marketing strategies, and demographic and geographic pinpoint targeting techniques. These applications provide the fuel for our Direct Marketing group to understand our clients’ target audiences in ways that produce results. And they drive greater readership and advertising value for our Shoppers publications.

# on the move
## for our customers



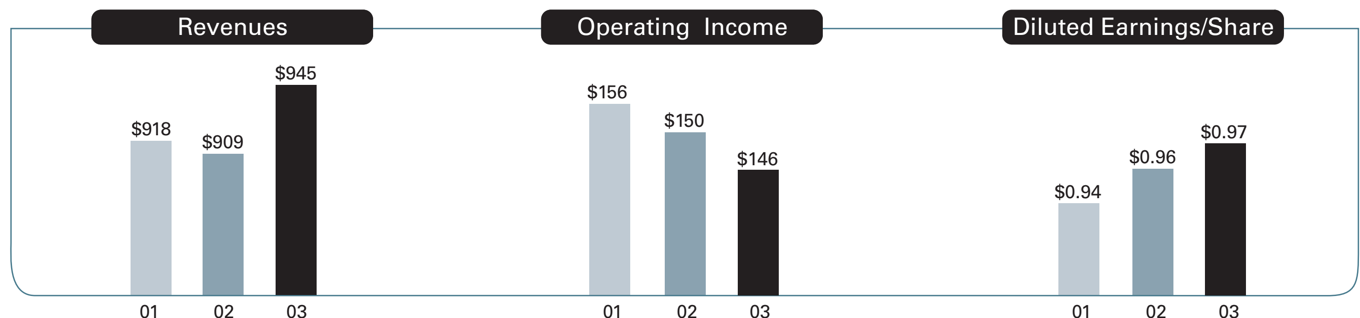
The people of Harte-Hanks are on the move in a marketing environment that's changing faster and faster. In 2003 we anticipated our customers' evolving needs by investing in new ways to "make it happen" for them. We continued to take intelligent risks in developing new products and services aimed at building on our strong solutions.

What sets Harte-Hanks apart from our competitors? Client focus and our unparalleled expertise in vertical markets. Thought leadership in technology and the excellence of our applications staff, enabling us to provide our clients with even greater value. Recent investments in shopper expansion, cutting-edge technology and talented people helping our customers increase their market share. And the way we measure our success: by our customers' success.

One result of our 2003 strategic initiatives was continued revenue and profit growth in our Shoppers publications. In Direct Marketing, it was a base-building year, as we won new business, enjoyed revenue growth and set the stage for profit improvement. Staying close to our customers is how we made this happen.

In Direct Marketing and in Shoppers, the people of Harte-Hanks are on the move for our customers.

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




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 $140, and diluted earnings per share of $0.82.

# on the move with solutions

From our roots as a regional newspaper company, we've evolved into a worldwide direct marketing and targeted media company that provides direct marketing services and shopper advertising to a wide range of local, regional, national and international clients. Our clients range from mid-sized to *Fortune 1000* companies in consumer and business markets across North America, Europe, South America and the Pacific Rim, to thousands of smaller retailers, service firms and individuals who use the effective targeting of our shopper publications in California and Florida.

**Direct Marketing solutions**

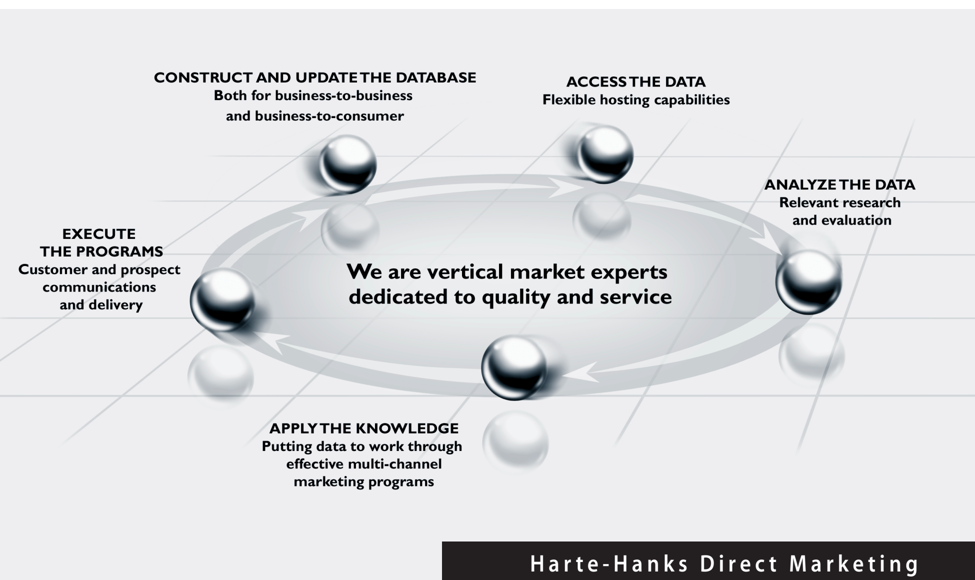
Harte-Hanks Direct Marketing is in the business of delivering ROI-driven solutions, empowering our clients to treat their customers in the most relevant ways. We uncover insight and knowledge about the purchasing behavior and preferences of our clients' customers. That information is applied to refine our clients' marketing models and business decisions over time, enabling clients to acquire new customers and improve their share of customer wallet.

We're on the move to increase return on marketing investment for clients. How? By providing services grouped around five solution points: Construct and update the database ➛ Access the data ➛ Analyze the data ➛ Apply the knowledge ➛ Execute the programs. We are thought leaders at each point in this process, expert at creating solutions — individual or linked end to end — for each of the vertical markets we serve.

**Shopper publications solutions**

As North America's largest owner, operator and distributor of shopper publications, Harte-Hanks sets the standard for meeting local needs in rapidly changing, diverse markets. Each week the *PennySaver* (California) and *The Flyer* (Florida) provide targeted advertising to more than ten million households.

Harte-Hanks Shoppers provide high-quality, flexible, cost-efficient solutions for a wide range of residential advertisers, and local, regional and national businesses. We target readers by geographic zone, clusters of zones surrounding advertiser location, demographic criteria, language and lifestyle. We offer advertisers not just a variety of options in print, but also the opportunity



to appear in online versions with interactive search functions.

In 2003, Shoppers implemented strategic initiatives to respond faster, more precisely and more efficiently to customers' needs: we expanded use of color; we increased automation to facilitate superior customer service and precision targeting; we enabled customers to preview and confirm their ads online; we launched Web-based services for national accounts; we placed the inventories of client auto dealers on our respective shoppers' Web sites; and we adopted digital proofing. In addition, we are expanding into new high-growth geographies as part of our initiative to increase shopper circulation through contiguous geographic expansion. And with the launch of targeted inserts, we've created opportunity for further penetration into the growing, influential U.S. Hispanic market.

In short, Harte-Hanks Shoppers are on the move for our customers.

**Data spark insights.**
**Insights mold action.**
**Action creates new data.**

Many large marketers have in-house information technology departments but no one to explain to marketing decision-makers what the data mean and how the organization should respond. The success of customer-centric marketing depends on how accurate, current and accessible the customer data are. This requires not just detailed databases, but also analysis and prediction to identify and target customers and prospects accurately.

That's where Harte-Hanks makes the critical difference and why marketers turn to us. Our everyday business is transforming data into valuable assets. The knowledge we create for clients through the data we capture, analyze and disseminate provides a crucial edge in developing the content of marketing messages, evaluating media channels and making critical choices about timing, pricing and targeting.

Our skill in applying this feedback helps our customers refine marketing communications continually and comprehensively. We provide clients with measurable, action-prompting insights. We help them use these insights to create strategies that meet the challenges of today's markets. In short, Harte-Hanks enables companies to market more intelligently and more profitably.

## FINANCIAL HIGHLIGHTS
(in thousands, except per share amounts)

| | 2003 | 2002 | 2001[1] |
|---|---|---|---|
| **Revenues** | 944,576 | 908,777 | 917,928 |
| **Operating income** | 146,487 | 150,288 | 155,853 |
| **Depreciation and amortization** | 30,033 | 32,728 | 32,697 |
| **Interest expense** | 855 | 1,208 | 3,076 |
| **Net income** | 87,362 | 90,745 | 91,700 |
| **Diluted earnings per share**[2] | 0.97 | 0.96 | 0.94 |
| **Capital expenditures** | 31,915 | 17,358 | 26,445 |
| **Average common and common equivalent shares outstanding - diluted**[2] | 89,982 | 94,872 | 97,174 |

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, net income of $79,684 (all figures are in thousands) and diluted earnings per share of $0.82.

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

**Comprehensive marketing solutions**

Harte-Hanks offers specialized services that are coordinated and integrated to drive behavior. In Shoppers that means ROP (run-of-press) advertising and inserts, online advertising, the use of color, and targeting with specialized products and geographic and demographic zoning. In Direct Marketing it means use of the appropriate media to reach and influence the target audience — traditional mail and e-mail, outbound calls to customers and inbound calls from prospects and customers, and both fulfillment and e-fulfillment. It also means proprietary solutions from the Trillium Software System® to a range of Allink® database products that are vertical-market focused and behaviorally driven. And it means using the Web to drive solutions, using print-on-demand when the value of personalization is evident, and building these solutions through an agency front end when strategic oversight is needed.

In short, Harte-Hanks has the technological and human capital to meet our clients' increasingly complex marketing needs.

Our solutions are tested in real time each day. We combine the tried and true with the most promising of the cutting edge, continuing to build our competitive advantages in direct and interactive media. Our marketing portal, *Allink on Demand*, is a secure, 24/7 Web site where our clients' branch managers, sales staff and other front-line constituencies can stage and execute direct marketing campaigns. Proven mailing lists, branded creative for customization and personalization, campaign feedback and reporting resources are just a few of the features front-line decision-makers can command with a click.

We expanded our *CI Technology Database* (CITDB) to include small and medium-sized businesses, fulfilling our clients' desire for action-inciting intelligence about this valuable, rapidly growing prospect segment. And we added permission-based e-mail for those clients who seek to reach their target audience through this medium.

Harte-Hanks solutions are supported by our worldwide presence. We make solutions available everywhere our clients do business, and are expanding internationally with our database offerings. We offer our growing portfolio of solutions either installed or as an application service provider (ASP). Our *Allink* suite meshes vertical industry expertise with optimum data management practices. These systems are packaged, integrated, scalable, open and targeted, with tools to identify, evaluate and enhance the value of direct marketing programs. Bundled products and services are available for the retail, financial services, insurance, pharmaceutical, automotive, high-tech and other important sectors.

Our *Trillium Software System* is acknowledged as the worldwide standard for ensuring data quality. Our *nTouch* suite includes Web-based services to query data and distribute prospect inquiries quickly, measure program performance, and calculate return on marketing investment.

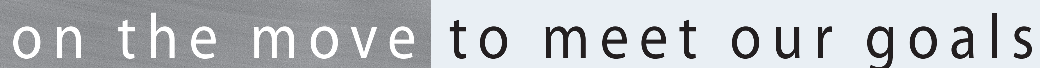
Our *Global Data Quality* (GDQ) offering, designed to deliver customer data quality (through data enhancement, management, enrichment and on-site consulting), is in the early stages of rollout and gaining traction. GDQ is now set for worldwide expansion.

Customers depend on Harte-Hanks to maximize the cost-effectiveness of their marketing programs. As their targeted audiences continue to become more skeptical and their competition for prospect and customer attention escalates, marketers need more than ever the support and expertise we provide. From the largest companies, to the thousands of mid-sized and small businesses, to individuals who depend on our shopper publications, customers rely on Harte-Hanks. Whether Harte-Hanks people are flying to a client meeting, driving to a press check, proofing online, or leading on a conference call developing the next generation of targeted marketing solutions, we're on the move for our customers. And we bring them results every day.

# on the move
## with vertical marketing expertise

Today's individual vertical markets are more highly differentiated and dynamic than ever. Breaking through the clutter while exceeding the mandates of core business sectors is challenging. Here, too, we're on the move. We've assembled teams of industry-leading experts in the intricacies of each sector. Our specialists have intimate knowledge of benchmarks, regulations, guidelines and industry standards that govern each vertical market. They use their strategic and tactical expertise to create solutions that help our clients build the future as well as deliver immediate marketing successes.

Harte-Hanks specialists are ahead of the curve in their industries. The complicated issues they monitor and master range from legislation that restricts telemarketing to changes in U.S. Postal Service requirements, privacy regulations, trends in insurance, and restrictions on prescription drug information. The clients of Shoppers and Direct Marketing depend on the understanding and insight Harte-Hanks brings to targeted media. Our corporate-level Privacy and Compliance Committee facilitates deep understanding of and adherence to privacy laws and ethics regimes. This committee is vigilant in helping our vertical market experts keep clients informed of privacy-related news and best practices.



# on the move to meet our goals

The mission of Harte-Hanks remains constant: to be a customer-focused, high-performance growth company. We strive to lead by providing complete marketing solutions that succeed in increasing the return on our customers' marketing investments. This is the vision we follow in making each decision.

To lead means to provide superior technological solutions that lead to greater efficiency and new opportunities, strategic expertise that leads our customers to smarter marketing, and the management skill that leads to maximizing our growth. We grow by exceeding our clients' expectations. No matter what services or products we provide, we deliver more than they anticipate — by understanding their vertical markets, by creating new value from data, and by offering new marketing solutions such as *Allink on Demand.*

Complete marketing solutions mean our customers can fulfill all their direct marketing needs with a suite of Harte-Hanks services and products that are seamless, integrated and delivered with strategic expertise. All the choices we make and the innovations we create are guided by the principle that the surest route to the continued success of Harte-Hanks is the success of our customers.

**Richard Hochhauser**
President & Chief Executive Officer

# on the move for results

**To our shareholders:**

Harte-Hanks helps clients make smart marketing decisions that they measure — and we gauge this by our own revenue growth. After a slow start — for the most part reflecting a lethargic U.S. and world economy and much uncertainty in the business community brought on by war in the Persian Gulf — we climbed out of a first-quarter deficit and met our goal of increased earnings per share for 2003. We also met the goals of continuing strong shopper performance and stabilizing and then growing revenue in direct marketing.

Once again, the people of Harte-Hanks delivered solid results in a number of businesses and industry sectors. In Direct Marketing, our High-Tech/Telecommunications and Select Markets organizations posted consistent, solid top-line revenue growth, reflecting growing penetration. Our Financial Services organization showed signs of a comeback late in the year. In Shoppers, our targeted local advertising channel, we again posted impressive gains in sales and earnings — Shoppers' seventh consecutive year of significant revenue growth.

In 2003, our diluted earnings per share increased to $0.97 on revenues of $945 million. Direct Marketing — which comprised 62 percent of total revenue — reversed the previous year's decrease and posted a 1.9 percent revenue gain. In Shoppers — which comprised the remaining 38 percent of total revenue — we again experienced excellent results, with revenue up by 7.4 percent, and operating income increasing by 4.6 percent. These numbers represent solid performance in a tough year.

Two areas of significant costs are medical expenses and workers' compensation claims (particularly in California). Like most U.S. companies, Harte-Hanks experienced costs higher than forecast when the year started. These increased costs coupled with aggressive revenue generation efforts yielded a lower return on sales. This is an area of focus for us in 2004.

Also during 2003, we repurchased 4.2 million shares, making a total 35.7 million shares repurchased since the company began this activity in 1997. An outstanding 4.2 million shares remain authorized for buyback. While we made no acquisitions during the year, the company actively evaluated dozens of opportunities seeking to find ones that would complement our offerings, penetrate new markets, and deliver necessary returns.

We have invested, and are investing, in short- and longer-term strategic growth initiatives in both Direct Marketing and Shoppers. Some are beginning to deliver revenue. Capital spending, including expenditures toward these initiatives, reached $31.9 million in 2003. Each of these initiatives, we believe, reflects the priorities of customers. They encompass new products and services that enhance our current offerings, and create new revenue opportunities in both existing and new markets. Let me identify some early successes.

*Allink on Demand* is a Web-based marketing services portal that enables corporations to create brand- and quality-compliant direct and interactive marketing programs that can be paid for and executed at the local level through branches, dealers, representatives, stores and franchisees that plug in to the portal. It's already in play in automotive and financial markets. During the year, we announced vertical offerings within our Allink suite of database products and services — specifically, retail, automotive, insurance, financial services and business-to-business.

To our *CI Technology Database* we have added North American small- and medium-sized business (SMB) locations (of 10 or more employees). The SMB market has captured attention in the high-tech marketplace, and our initiative provides unique access to technology buyers, needs and timing in these companies. As a result of this initiative, we already have more than 648,000 business locations profiled in the *CI Technology Database* worldwide. In addition, we have added permission-based e-mail address contacts at many of these sites, both in North America and in Europe, providing interactive means for business-to-business marketers to communicate with identified individuals.

Additional strategic initiatives in Direct Marketing advance our marketing services, customer data management and data quality offerings.

In Shoppers, our strategic growth initiatives include moving into a new facility in Northern California at the end of 2003. Expansion plans in the market are scheduled to roll out starting in 2004. Our household penetration in California alone is already in excess of 75 percent — and we plan to expand contiguously during the next five years. Today, more of our *PennySaver* and *Flyer* zones feature color advertising.

These investments are about gaining new revenue and market share, and many of them should position us well as the U.S. economy continues to improve.

And worldwide, the Trillium Software System is now available in Version 7, having been validated by SAP, Siebel Systems and Oracle (among others) for use in a range of business intelligence platforms and applications. The Trillium Software System also now recognizes Chinese and Korean alphabet character sets, as well as Japanese. We have deepened our relationship with customer care company Communiqué Direct in Australia, and have working relationships with near-shore and offshore call center partners in Costa Rica, the Philippines, Eastern Europe and India. Our international (non-U.S.) revenue now accounts for 8 percent of total direct marketing revenues.

Two issues that increasingly affect us domestically and internationally are privacy and security. Telephone marketing and e-mail legislation have not hurt our revenues, but restrictive public policy is being debated more than ever. Ongoing privacy management and the suppression of marketing offers in various media have been planned and "built in" to our database and marketing service offerings for years, providing revenue. Security, too, is an area where we continue to work closely with clients to help them safeguard their information assets.

I remain most pleased about the industry recognition that Harte-Hanks continues to enjoy. For the third consecutive year, both Harte-Hanks and our Trillium Software business were recognized by industry standard *DM Review* as top 100 providers of business intelligence. Trillium Software remained the single highest rated data quality software solution for a fourth consecutive year.

Client Fifth Third Bank was honored for stemming customer attrition through its use of *Allink Daily Deposit Builder*, our event-based marketing solution for the banking sector. This activity and result garnered a 1:1 Innovator Award from the editors of *1:1* magazine.

Three of our direct mail facilities were certified by the United States Postal Service's Mail Preparation Total Quality Management program, with more planned to follow in 2004. Harte-Hanks was the first Standard Mail service provider in the United States to receive this quality recognition.

In our Shoppers business, the Association of Free Community Papers named Orestes Baez — a regional vice president for our *PennySaver* in California — "Publisher of the Year" during its 2003 Annual Conference in Las Vegas.

It is these significant accolades, and others like them, for our people that resonate throughout Harte-Hanks and with our clients. Through our Online Learning Center, Online Resource Center and "Lunch 'n' Learn" Webinar programs, we ensure our people are fully briefed on company priorities — most importantly, serving, meeting and exceeding the needs of customers. This emphasis on training is vital as our offerings get more technically sophisticated and as we seek to differentiate further our people, processes and technology.

People also continue to invigorate our corporate management and board teams. At the corporate level, we are very pleased to have two new members join our Board of Directors, expanding membership to 10. The new directors are Judy C. Odom, who most recently was board chairman and chief executive officer of Software Spectrum, Inc.; and William F. Farley, a banking industry veteran and currently chief executive officer of Livingston Capital, a private investment business. Among our officers, we announced that Dean Blythe, who had served for nearly two years as our vice president, legal and secretary, was appointed senior vice president and chief financial officer. Jessica Huff was named vice president, finance and controller.

The last three years have challenged the supply side of our industry to be increasingly accountable for every dollar invested, to accomplish programs with fewer staff layers and people, and to generate more revenue and profit from fewer dollars invested. These tough challenges, however, have a silver lining. There's never been a better time to be a direct marketer and in targeted media...where the focus never waivers from precision, strict measurement, accountability and continuous improvement. As direct and targeted marketers, we are on the move every day, doing more with less and finding value where others don't. At Harte-Hanks, our team is dedicated to helping our clients produce greater customer return. We "make it happen" for them, for our shareholders, and for all our stakeholders.

# financials

# 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 877 separate editions reaching more than 10 million households in California and Florida each week.

Harte-Hanks derives its revenues from the sale of direct marketing services and shopper 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 and transportation.

**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 2001 numbers have been restated as if SFAS No. 142 had been adopted for the year.

Operating results were as follows:

| *In thousands* | 2003 | % Change | 2002 | % Change | 2001[1] |
|---|---|---|---|---|---|
| Revenues | $ 944,576 | 3.9 | $ 908,777 | -1.0 | $ 917,928 |
| Operating expenses | 798,089 | 5.2 | 758,489 | -0.5 | 762,075 |
| Operating income | $ 146,487 | -2.5 | $ 150,288 | -3.6 | $ 155,853 |

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 expenses of $778,298 and operating income of $139,630.

Consolidated revenues increased 3.9% to $944.6 million while operating income declined 2.5% to $146.5 million in 2003 compared to 2002. Overall operating expenses increased 5.2% to $798.1 million. The Company's overall results reflect revenue increases in both its Direct Marketing and Shopper segments. Declines in operating income in the Company's Direct Marketing segment were partially offset by increased operating income in the Shopper segment.

The Company's overall 2002 results reflect revenue and operating income declines in its Direct Marketing segment, partially offset by increased revenue and operating income from the Shopper segment.

**Direct Marketing**

Direct Marketing operating results were as follows:

| *In thousands* | 2003 | % Change | 2002 | % Change | 2001[1] |
|---|---|---|---|---|---|
| Revenues | $ 584,804 | 1.9 | $ 573,826 | -4.7 | $ 601,901 |
| Operating expenses | 508,163 | 3.7 | 489,954 | -2.9 | 504,730 |
| Operating income | $ 76,641 | -8.6 | $ 83,872 | -13.7 | $ 97,171 |

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 expenses of $516,881 and operating income of $85,020.

Direct Marketing revenues increased $11.0 million, or 1.9%, in 2003 compared to 2002. Direct Marketing had a challenging first half of 2003 as the war in Iraq and sluggish U.S. economy negatively impacted Direct Marketing's business. This slow start was difficult to recover from and is reflected in the full year 2003 results. Direct Marketing revenues stabilized in the second quarter of 2003, and this performance was followed by modest growth in the second half of the year.

From a vertical market perspective, revenues from the high-tech/telecom vertical market grew throughout 2003, ending up with double-digit growth for the year over 2002. The company's select market group, particularly the government/non-profit and manufacturing industries, also had growth in each quarter of 2003 and ended up with double-digit growth for the year over 2002. Revenues from the retail vertical market, Direct Marketing's largest vertical market in terms of annual revenue, were flat in the first quarter of 2003 and then declined each remaining quarter of 2003 versus the same periods of 2002, ending the year down compared to full year 2002. Revenues from the financial services vertical market were down for the first three quarters of 2003 and the full year of 2003 compared to the same quarters of 2002, but rebounded to show solid growth in the fourth quarter of 2003 compared to the fourth quarter of 2002. Revenues from the pharmaceutical/healthcare vertical market were down in the first quarter, but increased in the last three quarters of 2003 compared to 2002 and ended up flat for the full year 2003 compared to 2002.

From a service offering perspective, Direct Marketing experienced increased revenues in business-to-business telesales, technical support, account management and personalized direct mail. These increases were partially offset by revenue declines in data processing, fulfillment, data sales, logistics operations and internet services.

The Company has not seen any material change in the competitive landscape during 2003. Revenues from the Company's vertical markets are impacted by the economic fundamentals of each industry as well as the financial condition of specific customers.

Operating expenses increased $18.2 million, or 3.7%, in 2003 compared to 2002. Labor costs increased $4.6 million as a result of higher payrolls due to higher volumes, and higher healthcare costs. Production and distribution costs increased $16.7 million, primarily due to higher temporary labor costs and outsourcing costs. General and administrative expenses increased $0.1 million due to an increase in professional

services, partially offset by a decrease in business services. Depreciation expense decreased $3.2 million due to lower capital expenditures in 2002 than in recent prior years. Direct Marketing's largest cost components are labor and transportation, and both of these costs are variable and tend to fluctuate with revenues and the demand for the Company's Direct Marketing services. Continuing increases in healthcare costs also affected Direct Marketing's total labor costs during 2003 and are expected to continue to impact the segment's labor costs and total operating expenses in 2004.

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 vertical market sector were flat compared to 2001. The segment's select markets group had increased revenues, 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.

**Shoppers**

Shoppers operating results were as follows:

| *In thousands* | 2003 | % Change | 2002 | % Change | 2001 [1] |
|---|---|---|---|---|---|
| Revenues | $ 359,772 | 7.4 | $ 334,951 | 6.0 | $ 316,027 |
| Operating expenses | 281,765 | 8.2 | 260,387 | 4.8 | 248,557 |
| Operating income | $ 78,007 | 4.6 | $ 74,564 | 10.5 | $ 67,470 |

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 expenses of $252,629 and operating income of $63,398.

Shoppers revenues increased $24.8 million, or 7.4%, in 2003 compared to 2002. Revenue increases were the result of improved sales in established markets, geographic expansions into new neighborhoods, household growth in existing neighborhoods in California and Florida and the once every six year occurrence of one extra publication week in 2003. Total Shoppers circulation increased by approximately 485,000 households during 2003 and at December 31, 2003 Shoppers circulation reached approximately 10.5 million households (including 220,000 households in South Orange County, California where Shoppers publishes two editions each week). During the year distribution for the Harte-Hanks Shoppers publication *The Flyer*, located in South Florida, expanded geographically by 27,700 households in the South Broward County market, 15,000 homes in Fort Lauderdale and 66,000 homes in Pompano Beach and Coconut Creek. The Harte-Hanks Shoppers *Pennysaver* publication in Southern California increased its geographic coverage of the Southeast Los Angeles market by 44,000 households, added 26,000 homes in the Silverlake neighborhood and expanded into Bakersfield, adding 167,000 homes. The Company began moving into a new facility with greater capacity in Northern California in the fourth quarter of 2003 in order to further expand circulation in that area. The Company believes that expansions provide increased revenue opportunities and plans to cover an additional circulation of 300,000 to 500,000 households per year in each of the next few years in Northern California, Southern California and South Florida. Newer areas initially tend to contribute less from a revenue per thousand perspective than existing areas, and in fact are typically expected to be less profitable or even unprofitable until the publications in those areas mature.

From a product-line perspective, Shoppers had growth in both run-of-press (ROP, or in-book) advertising, primarily core sales and real estate-related advertising, and its distribution products. These increases were partially offset by declines in automotive-related ROP advertising and decreased coupon book revenues.

Excluding the extra publication week mentioned above, Shoppers revenue increased 6.0% over 2002. In 2004 Shoppers circulation will return to the normal 52 week publication cycle.

Shoppers operating expenses rose $21.4 million, or 8.2%, in 2003 compared to 2002. Labor costs increased $7.3 million due to increased staff, higher volumes and higher benefit costs. Production costs increased $9.9 million, including additional postage of $5.2 million due to higher postage rates for the first half of 2003 and increased volume for the full year. General and administrative costs increased $3.7 million due to increased insurance costs (including workers compensation), promotion costs and bad debt expense. Depreciation expense increased $0.5 million due to new capital

investments to support future growth. Shoppers operating expenses were also impacted by the move into the new facility in Northern California and the once every six year occurrence of one extra publication week in 2003. Shoppers' largest cost components are labor, postage and paper. Shoppers' labor costs are variable and tend to fluctuate with volumes and revenues. Continuing increases in healthcare costs are also expected to impact Shoppers' total labor costs and operating expenses in 2004. Standard postage rates increased at the beginning of the third quarter of 2002 and it is unclear at this time when the next increase might occur. Increased postage rates would impact Shoppers' total production costs. Newsprint prices began to climb in the fourth quarter of 2003 and are expected to continue to increase in 2004, which will impact Shoppers total production costs in 2004.

Shoppers 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 ROP (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.

Shoppers 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.

**Acquisitions**

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

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

**Interest Expense/Interest Income**

Interest expense decreased $0.4 million in 2003 over 2002 due primarily to lower outstanding debt levels of the Company's revolving credit facilities. The decrease in interest expense in 2003 was also a result of lower rates in 2003 compared to 2002. Interest expense decreased $1.9 million in 2002 compared to 2001 due primarily to lower outstanding debt levels of the Company's revolving credit facilities and lower interest expense in 2002 compared to 2001. The Company's debt at December 31, 2003 and 2002 is described in Note D of the "Notes to Consolidated Financial Statements," included herein.

Interest income decreased $0.1 million in 2003 compared to 2002 due to lower interest rates and lower average investment balances in 2003 compared to 2002. Interest income decreased $0.2 million in 2002 compared to 2001 due to lower interest rates in 2002 compared to 2001.

**Other Income and Expense**

Other net expense for 2003 and 2002 primarily consists of balance-based bank charges and stockholders expenses.

**Income Taxes**

Income taxes decreased $0.1 million in 2003 and $0.4 million in 2002 due to lower income levels. The effective income tax rate was 39.3%, 38.4% and 38.3% in 2003, 2002 and 2001, 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 2003 included $31.9 million for capital expenditures and $0.3 million for acquisition-related payments. The capital expenditures consisted primarily of product development and enhancement, additional computer capacity, systems, new press equipment and equipment upgrades for the Direct Marketing segment. The Shopper segment's capital expenditures were primarily related to the Northern California facility expansion, common system software, additional computers and other production equipment. The acquisition-related payments, which all relate to prior years' acquisitions, were made in the Direct Marketing segment.

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.

**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.

The Company's accounting policy for revenue recognition has an impact on its reported results and relies on certain estimates that require judgments on the part of management. The portion of the Company's revenue that is most subject to estimates and judgments is revenue recognized using the percentage of completion method, as discussed below.

Specifically, Direct Marketing revenue from certain projects and certain services such as database build services, Internet web design, market research and analytical services may be billed 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. Management estimates and judgments are used in connection with the revenue recognized in these instances. Should actual costs differ significantly from the original estimated costs, the timing of revenues and overall profitability of the contract could be impacted. Contracts accounted for under the percentage of completion method comprised less than 7% of total Direct Marketing revenue and less than 4% of total Harte-Hanks revenue for the years ended December 31, 2003, 2002 and 2001.

For all sales the Company requires 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 $1.6 million, $1.2 million and $4.4 million for the years ended December 31, 2003, 2002 and 2001, respectively. While the Company believes its reserve estimate to be appropriate, the Company may find it necessary to adjust its allowance for doubtful accounts if future bad debt expense exceeds the estimated reserve. Given the significance of accounts receivable to the Company's consolidated financial statements, the determination of net realizable values is considered to be a critical accounting estimate.

*Reserve for Healthcare, Workers' Compensation, Automobile and General Liability*

The Company has a $150,000 deductible for specific healthcare claims with an aggregate claims deductible of 125% of the expected claims for a given year. The Company has

a $250,000 deductible for automobile and general liability. The Company's deductible for workers' compensation decreased from $1.0 million to $500,000 in October 2003. Management makes various subjective judgments about a number of factors in determining the Company's reserve for healthcare, workers' compensation, automobile and general liability insurance, and the related expense. If ultimate losses were 10% higher than the Company's estimate at December 31, 2003, earnings would be impacted by up to $725,000, net of taxes. The amount that earnings would be impacted is dependent on the claim year and the Company's deductible levels for that plan year. 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 Direct Marketing 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.

Both the Direct Marketing and Shoppers segments are tested for impairment as of November 30 of each year, after the annual forecasting process for the upcoming fiscal year has been completed. The Company has not recorded an impairment loss in any of the three years ended December 31, 2003. Significant estimates utilized in the Company's discounted cash flow model include weighted average cost of capital and the long-term rate of growth for each of the Company's reporting segments. These estimates require management's judgment. Any significant changes in key assumptions about the Company's businesses and their prospects, or changes in market conditions, could have an impact on this annual analysis.

At December 31, 2003 and 2002 the Company's goodwill balance was $437.2 million, net of $82.0 million of accumulated amortization, and $436.8 million, net of $82.0 million of accumulated amortization, respectively. Amortization expense related to goodwill was $16.2 million for the year ended December 31, 2001. Based upon the Company's analysis as of December 31, 2003, the estimated fair values of the Company's reporting units was well in excess of the reporting units' carrying values.

**Liquidity and Capital Resources**

Cash provided by operating activities for 2003 was $124.1 million, down $17.6 million compared to 2002. The decrease in 2003 primarily relates to an increase in accounts receivable at December 31, 2003 over the December 31, 2002 balance due to increased revenues in 2003 over 2002, and a $12.6 million pension plan funding payment made in September 2003. Net cash outflows from investing activities were $31.6 million for 2003 compared to net cash outflows of $20.7 million in 2002. The increase in 2003 primarily relates to higher capital investments, partially offset by a lower amount spent on acquisitions in 2003 than 2002. Net cash outflows from financing activities in 2003 were $85.3 million compared to $126.4 million in 2002. The decrease in 2003 primarily relates to lower net repayments of debt and a lower overall amount spent repurchasing stock in 2003 than 2002.

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, stock repurchases, capital expenditures and dividends for the foreseeable future. As of December 31, 2003, the Company had $120.0 million of unused borrowing capacity under its credit facility.

At December 31, 2003, the Company had outstanding letters of credit in the amount of $14.7 million. These letters of credit renew annually and exist to support the Company's insurance programs relating to workers' compensation, automobile and general liability, and leases. The Company had no other off-balance sheet arrangements at December 31, 2003.

The Company's contractual obligations at December 31, 2003 are as follows:

| *In thousands* | Total | 2004 | 2005 | 2006 | 2007 | 2008 | Thereafter |
|---|---|---|---|---|---|---|---|
| Long-term debt | $5,000 | $ – | $5,000 | $ – | $ – | $ – | $ – |
| Operating leases | 95,740 | 23,044 | 17,595 | 12,995 | 9,914 | 7,357 | 24,835 |
| Deferred compensation liability | 5,993 | 50 | 500 | 650 | 635 | 600 | 3,558 |
| Total contractual cash obligations | $106,733 | $23,094 | $23,095 | $13,645 | $10,549 | $7,957 | $28,393 |

**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, including the recent creation of do-not-call lists, 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*

Although the Company did not complete any acquisitions in 2003 or 2002, it continues to pursue acquisition opportunities, primarily in its Direct Marketing segment. 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 and within each of its vertical markets. The Company's Shopper business competes for advertising, as well as for readers, with other print and electronic media. Competition comes from local and regional newspapers, magazines, radio, broadcast and cable television, shoppers and other communications media that operate in the Company's markets. The extent and nature of such competition are, in large part, determined by the location and demographics of the markets targeted by a particular advertiser, and the number of media alternatives in those markets. Failure 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 and from time to time and in the foreseeable future will likely remain a limited resource.

*Postal Rates*

The Company's Shoppers 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 have grown moderately as a result of this increase and are expected to grow further as a result of 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 or the threat of 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 operation disruptions and a shortage of supplies and labor related to such a war or threat of war.

| *In thousands, except per share and share amounts* | December 31, 2003 | December 31, 2002 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents | **$32,151** | $25,026 |
| Accounts receivable *(less allowance for doubtful accounts of $1,240 in 2003 and $3,025 in 2002)* | **152,703** | 137,679 |
| Inventory | **5,213** | 5,299 |
| Prepaid expenses | **13,816** | 14,070 |
| Current deferred income tax asset | **7,682** | 8,129 |
| Other current assets | **5,732** | 8,409 |
| Total current assets | **217,297** | 198,612 |
| Property, plant and equipment | | |
| Land | **3,423** | 3,335 |
| Buildings and improvements | **36,817** | 32,442 |
| Software | **62,955** | 53,279 |
| Equipment and furniture | **183,744** | 178,684 |
| | **286,939** | 267,740 |
| Less accumulated depreciation and amortization | **(194,987)** | (179,741) |
| | **91,952** | 87,999 |
| Software development and equipment installations in progress | **5,795** | 6,155 |
| Net property, plant and equipment | **97,747** | 94,154 |
| Intangible and other assets | | |
| Goodwill *(less accumulated amortization of $81,973 in 2003 and 2002)* | **437,156** | 436,800 |
| Other intangible assets *(less accumulated amortization of $2,333 in 2003 and $1,733 in 2002)* | **2,667** | 3,267 |
| Other assets | **4,263** | 3,899 |
| Total intangible and other assets | **444,086** | 443,966 |
| Total assets | **$759,130** | $736,732 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities | | |
| Accounts payable | **$47,891** | $40,746 |
| Accrued payroll and related expenses | **22,808** | 21,854 |
| Customer deposits and unearned revenue | **48,658** | 41,775 |
| Income taxes payable | **7,776** | 9,338 |
| Other current liabilities | **6,939** | 8,048 |
| Total current liabilities | **134,072** | 121,761 |
| Long-term debt | **5,000** | 16,300 |
| Other long-term liabilities *(including deferred income taxes of $35,853 in 2003 and $21,602 in 2002)* | **64,460** | 66,138 |
| Total liabilities | **203,532** | 204,199 |
| Stockholders' equity | | |
| Common stock, $1 par value, authorized: 250,000,000 shares Issued 2003: 113,280,794; 2002: 111,534,630 shares | **113,281** | 111,535 |
| Additional paid-in capital | **235,996** | 216,149 |
| Retained earnings | **798,974** | 722,231 |
| Less treasury stock, 2003: 25,788,502; 2002: 21,329,896 shares at cost | **(573,863)** | (491,793) |
| Accumulated other comprehensive loss | **(18,790)** | (25,589) |
| Total stockholders' equity | **555,598** | 532,533 |
| Total liabilities and stockholders' equity | **$759,130** | $736,732 |

See Notes to Consolidated Financial Statements

| *In thousands, except per share amounts* | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| Revenues | **$944,576** | $908,777 | $917,928 |
| Operating expenses | | | |
| Payroll | **336,333** | 324,733 | 335,913 |
| Production and distribution | **351,405** | 324,806 | 313,639 |
| Advertising, selling, general and administrative | **80,318** | 76,222 | 79,826 |
| Depreciation | **29,433** | 32,128 | 32,079 |
| Goodwill and intangible amortization | **600** | 600 | 16,841 |
| Total operating expenses | **798,089** | 758,489 | 778,298 |
| Operating income | **146,487** | 150,288 | 139,630 |
| Other expenses (income) | | | |
| Interest expense | **855** | 1,208 | 3,076 |
| Interest income | **(168)** | (274) | (498) |
| Other, net | **1,895** | 2,004 | 4,614 |
| | **2,582** | 2,938 | 7,192 |
| Income before income taxes | **143,905** | 147,350 | 132,438 |
| Income tax expense | **56,543** | 56,605 | 52,754 |
| Net income | **$87,362** | $90,745 | $79,684 |
| Basic earnings per common share | **$0.99** | $0.98 | $0.84 |
| Weighted-average common shares outstanding | **88,541** | 92,648 | 94,808 |
| Diluted earnings per common share | **$0.97** | $0.96 | $0.82 |
| Weighted-average common and common equivalent shares outstanding | **89,982** | 94,872 | 97,174 |

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:

| | 2003 | 2002 | 2001 |
|---|---|---|---|
| Net income | **$87,362** | $90,745 | $79,684 |
| Add back: Goodwill amortization (net of tax effect) | **–** | – | 12,016 |
| Adjusted net income | **$87,362** | $90,745 | $91,700 |
| Basic earnings per common share: | | | |
| Net income | **$0.99** | $0.98 | $0.84 |
| Add back: Goodwill amortization (net of tax effect) | **–** | – | 0.13 |
| Adjusted net income | **$0.99** | $0.98 | $0.97 |
| Diluted earnings per common share: | | | |
| Net income | **$0.97** | $0.96 | $0.82 |
| Add back: Goodwill amortization (net of tax effect) | **–** | – | 0.12 |
| Adjusted net income | **$0.97** | $0.96 | $0.94 |

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

See Notes to Consolidated Financial Statements

| *In thousands* | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| Cash flows from operating activities | | | |
| Net income | **$87,362** | $90,745 | $79,684 |
| Adjustments to reconcile net income to net cash provided by operations: | | | |
| Depreciation | **29,433** | 32,128 | 32,079 |
| Goodwill and intangible amortization | **600** | 600 | 16,841 |
| Amortization of option-related compensation | **100** | 99 | 206 |
| Deferred income taxes | **12,047** | 8,878 | 2,470 |
| Other, net | **379** | 741 | 4,464 |
| Changes in operating assets and liabilities, net of effects from acquisitions and divestitures: | | | |
| (Increase) decrease in accounts receivable, net | **(15,024)** | 730 | 47,578 |
| Decrease in inventory | **86** | 536 | 425 |
| (Increase) decrease in prepaid expenses and other current assets | **2,931** | (2,762) | (124) |
| Increase (decrease) in accounts payable | **7,145** | (2,244) | (17,054) |
| Increase (decrease) in other accrued expenses and other liabilities | **7,186** | 8,884 | (12,350) |
| Other, net | **(8,181)** | 3,302 | (1,278) |
| Net cash provided by operating activities | **124,064** | 141,637 | 152,941 |
| Cash flows from investing activities | | | |
| Acquisitions | **(343)** | (3,791) | (28,230) |
| Purchases of property, plant and equipment | **(31,915)** | (17,358) | (26,445) |
| Proceeds from the sale of property, plant and equipment | **621** | 439 | 492 |
| Other investing activities | **–** | – | 801 |
| Net cash used in investing activities | **(31,637)** | (20,710) | (53,382) |
| Cash flows from financing activities | | | |
| Long-term borrowings | **45,000** | 34,000 | 282,000 |
| Payments on debt | **(56,300)** | (66,531) | (292,000) |
| Issuance of common stock | **12,885** | 14,113 | 9,131 |
| Issuance of treasury stock | **125** | 110 | 75 |
| Purchase of treasury stock | **(76,393)** | (98,912) | (83,664) |
| Dividends paid | **(10,619)** | (9,149) | (7,561) |
| Net cash used in financing activities | **(85,302)** | (126,369) | (92,019) |
| Net increase (decrease) in cash and cash equivalents | **7,125** | (5,442) | 7,540 |
| Cash and cash equivalents at beginning of year | **25,026** | 30,468 | 22,928 |
| Cash and cash equivalents at end of year | **$32,151** | $25,026 | $30,468 |

See Notes to Consolidated Financial Statements

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

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total Stockholders' Equity |
|---|---|---|---|---|---|---|
| Balance at January 1, 2001 | $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 |
| **Common stock issued — employee benefit plans** | **213** | **3,199** | **–** | **–** | **–** | **3,412** |
| **Exercise of stock options for cash and by surrender of shares** | **1,533** | **10,392** | **–** | **(5,828)** | **–** | **6,097** |
| **Tax benefit of options exercised** | **–** | **6,282** | **–** | **–** | **–** | **6,282** |
| **Dividends paid ($0.12 per share)** | **–** | **–** | **(10,619)** | **–** | **–** | **(10,619)** |
| **Treasury stock issued** | **–** | **(26)** | **–** | **151** | **–** | **125** |
| **Treasury stock repurchased** | **–** | **–** | **–** | **(76,393)** | **–** | **(76,393)** |
| **Comprehensive income, net of tax:** | | | | | | |
| **Net income** | **–** | **–** | **87,362** | **–** | **–** | **87,362** |
| **Adjustment for minimum pension liability (net of tax of $2,652)** | **–** | **–** | **–** | **–** | **4,053** | **4,053** |
| **Foreign currency translation adjustment** | **–** | **–** | **–** | **–** | **2,746** | **2,746** |
| **Total comprehensive income** | | | | | | **94,161** |
| **Balance at December 31, 2003** | **$113,281** | **$235,996** | **$798,974** | **$(573,863)** | **$(18,790)** | **$555,598** |

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 $1.6 million, $1.2 million and $4.4 million for the years ended December 31, 2003, 2002 and 2001, 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, "Goodwill and Other Intangible Assets." 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 Direct Marketing 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.

Both the Direct Marketing and Shoppers segments are tested for impairment as of November 30 of each year, after the annual forecasting process for the upcoming fiscal year has been completed. Based on the results of the Company's impairment test, the Company has not recorded an impairment loss in any of the three years ended December 31, 2003.

At December 31, 2003 and 2002 the Company's goodwill balance was $437.2 million, net of $82.0 million of accumulated amortization, and $436.8 million, net of $82.0 million of accumulated amortization, respectively. Amortization expense related to goodwill was $16.2 million for the year ended December 31, 2001.

The changes in the carrying amount of goodwill for the year ended December 31, 2003, are as follows:

| *In thousands, except per share amounts* | Direct Marketing | Shoppers | Total |
|---|---|---|---|
| Balance at December 31, 2002 | $312,454 | $124,346 | $436,800 |
| Additional purchase consideration | 356 | – | 356 |
| Balance at December 31, 2003 | $312,810 | $124,346 | $437,156 |

As of December 31, 2003 and 2002 the Company does not have any intangibles with indefinite useful lives other than goodwill.

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, 2003 and 2002 all of the Company's other intangibles with definite useful lives are related to the Company's Direct Marketing segment. At December 31, 2003 and 2002, the balance of other intangibles was $2.7 million, net of $2.3 million of accumulated amortization, and $3.3 million, net of $1.7 million of accumulated amortization. Amortization expense related to other intangibles with definite useful lives was $0.6 million for each of the years ended December 31, 2003, 2002 and 2001. Expected amortization expense is $0.6 million for the years ending December 31, 2004 and 2005, and $0.4 million for the years ending December 31, 2006, 2007 and 2008.

*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, 2003 | 2002 | 2001 |
|---|---|---|---|
| Net income — as reported | **$87,362** | $90,745 | $79,684 |
| Stock-based employee compensation expense, included in reported net income, net of related tax effects | **61** | 61 | 124 |
| Stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects | **(3,899)** | (4,411) | (4,362) |
| Net income — pro forma | **$83,524** | $86,395 | $75,446 |
| Basic earnings per share — as reported | **$0.99** | $0.98 | $0.84 |
| Basic earnings per share — pro forma | **$0.94** | $0.93 | $0.80 |
| Diluted earnings per share — as reported | **$0.97** | $0.96 | $0.82 |
| Diluted earnings per share — pro forma | **$0.93** | $0.91 | $0.78 |

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 2003, 2002 and 2001:

| | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| Expected dividend yield | **0.6%** | 0.5% | 0.5% |
| Expected stock price volatility | **27.2%** | 27.8% | 21.0% |
| Risk free interest rate | **3.6%** | 5.4% | 5.7% |
| Expected life of options | **3-10 years** | 3-10 years | 3-10 years |

*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 Healthcare, Workers' Compensation, Automobile and General Liability*

The Company has a $150,000 deductible for specific healthcare claims with an aggregate claims deductible of 125% of the expected claims for a given year. The Company has a $250,000 deductible for automobile and general liability. The Company's deductible for workers' compensation decreased from $1.0 million to $500,000 in October 2003. The Company's insurance administrator provides the Company with estimated loss reserves, based upon its experience dealing with similar types of claims, as well as amounts paid to date against these claims. The Company applies actuarial factors to both insurance estimated loss reserves and to paid claims and then determines reserve levels, taking into account these calculations. 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*

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The Statement requires that an issuer classify a financial instrument that is within the scope of SFAS No. 150 as a liability (or an asset in some circumstances) when many of those instruments were previously classified as equity. The Statement expands the definition of liabilities to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares, depending on the nature of the relationship established between the holder and the issuer. The Company does not have any financial instruments that fall under the scope of SFAS No. 150, and the adoption of SFAS No. 150 in May 2003 did not affect the Company's financial position or results of operations.

In December 2003, the Financial Accounting Standards Board revised SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits." This revision retained the disclosure requirements contained in the original SFAS No. 132, but added additional disclosures about the types of plan assets, investment strategy, measurement dates, plan obligations, cash flows, and components of net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. This revision also requires certain disclosures about pensions and other postretirement benefits in interim financial statements. The annual disclosure provisions of SFAS No. 132, as revised, are effective for fiscal years ending after December 15, 2003, and are included in Note F of these consolidated financial statements. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2003.

In December 2003, the Financial Accounting Standards Board issued Interpretation 46R, "Consolidated Financial Statements" (FIN 46R). FIN 46R addresses the application of Accounting Research Bulletin 51, "Consolidated Financial Statements," to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. FIN 46R is effective for fiscal years ending after December 15, 2003. The Company does not have any variable interest entities and the adoption of FIN 46R by the Company in December 2003 did not affect the Company's 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.

The total cash outlay in 2003 related to acquisitions was $0.3 million. 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 2001 acquisition of SSS pending the final settlement of the acquired company's working capital amount. This holdback amount was settled in 2002.

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 pro forma 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 sold equity investments in 2001, which were classified as available-for-sale. Proceeds from the sale of these long-term investments in 2001 were $0.8 million. Gross realized losses included in 2001 income were $3.4 million. Gross losses were determined using the average cost method. At December 31, 2003 and 2002 the Company owned no equity investments.

**Note D – Long-Term Debt**

Cash payments for interest were $0.9 million, $1.3 million, and $3.4 million for the years ended December 31, 2003, 2002 and 2001, respectively.

| *In thousands* | December 31, 2003 | 2002 |
|---|---|---|
| Revolving loan commitment, various interest rates based on EUROLIBOR (effective rate of 1.69% at December 31, 2003), due October 17, 2005 | **$5,000** | $15,000 |
| Revolving loan commitment, various interest rates based on EURIBOR, due July 20, 2003 | **–** | 1,300 |
| Less current maturities | **–** | – |
| | **$5,000** | $16,300 |

*Credit Facilities*

On October 18, 2002 the Company obtained a three-year $125 million variable rate unsecured revolving credit facility. 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%. As of December 31, 2003, the Company had $120 million of unused borrowing capacity under this credit agreement. This credit facility contains both affirmative and negative covenants, the most significant of which are that the Company's leverage ratio, as defined in the credit facility, must not exceed 3.00 to 1.00, and that the Company's interest coverage ratio, as defined, cannot be less than 2.75 to 1.00. If the Company were not in compliance with any of these affirmative or negative covenants a default would occur and the lenders could terminate their commitments under the credit facility and declare all outstanding borrowings, interest and fees due. The Company has been in compliance with all covenants since obtaining the credit facility. The credit facility does not contain any cross-default provisions.

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 with borrowings under the Company's three-year revolving credit facility. All borrowings under the increased amount of 1.2 million Euros were repaid on July 20, 2003 with borrowings under the Company's 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, 2003 | 2002 | 2001 |
|---|---|---|---|
| **Current** | | | |
| Federal | **$37,820** | $41,602 | $43,010 |
| State and local | **6,376** | 6,026 | 6,776 |
| Foreign | **300** | 99 | 498 |
| Total current | **$44,496** | $47,727 | $50,284 |
| **Deferred** | | | |
| Federal | **$10,825** | $7,087 | $2,716 |
| State and local | **2,435** | 1,791 | (246) |
| Foreign | **(1,213)** | – | – |
| Total deferred | **$12,047** | $8,878 | $2,470 |
| Total income tax expense | **$56,543** | $56,605 | $52,754 |

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, 2003 | | 2002 | | 2001 | |
|---|---|---|---|---|---|---|
| Computed expected income tax expense | **$50,367** | 35% | $51,572 | 35% | $ 46,353 | 35% |
| Net effect of state income taxes | **5,717** | 4% | 4,922 | 3% | 4,368 | 3% |
| Effect of goodwill amortization | **–** | 0% | – | 0% | 1,607 | 1% |
| Change in the beginning of the year balance of the valuation allowance | **10** | 0% | 159 | 0% | (124) | 0% |
| Other, net | **449** | 0% | (48) | 0% | 550 | 0% |
| Income tax expense for the period | **$56,543** | 38% | $56,605 | 38% | $52,754 | 40% |

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

| In thousands | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| Results of operations | **$56,543** | $56,605 | $52,754 |
| Stockholders' equity | **(3,630)** | (27,886) | (5,935) |
| Total | **$52,913** | $28,719 | $46,819 |

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, 2003 | 2002 |
|---|---|---|
| **Deferred tax assets** | | |
| Deferred compensation and retirement plan | **$10,598** | $16,270 |
| Accrued expenses not deductible until paid | **4,451** | 4,204 |
| Accounts receivable, net | **343** | 978 |
| Other, net | **211** | 190 |
| Foreign net operating loss carryforwards | **1,214** | – |
| State net operating loss carryforwards | **597** | 848 |
| Capital loss carryforward | **492** | 492 |
| Total gross deferred tax assets | **17,906** | 22,982 |
| Less valuation allowance | **(1,089)** | (1,277) |
| Net deferred tax assets | **16,817** | 21,705 |
| **Deferred tax liabilities** | | |
| Property, plant and equipment | **(12,819)** | (12,134) |
| Goodwill | **(31,299)** | (23,404) |
| State income tax | **(870)** | 360 |
| Total gross deferred tax liabilities | **(44,988)** | (35,178) |
| Net deferred tax liabilities | **$(28,171)** | $(13,473) |

As of December 31, 2003 and 2002 the Company had net operating loss and capital loss carryforwards which are available to reduce future taxable income and which will begin to expire in 2006.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Based on the expectation of future taxable income and that the deductible temporary differences will offset existing taxable temporary differences, management believes it is more likely than not the Company will realize the benefits of these deductible differences, net of the existing valuation allowances, at December 31, 2003.

The valuation allowance for deferred tax assets as of January 1, 2002, was $898,000. The valuation allowance at December 31, 2003, relates to state net operating losses of $597,000 and capital losses of $492,000, which are not expected to be realized. The valuation allowance at December 31, 2002, relates to state net operating losses of $784,000 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 $39.9 million, $37.8 million and $38.0 million in 2003, 2002 and 2001, 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, 2003 | 2002 |
|---|---|---|
| **Change in benefit obligation** | | |
| Benefit obligation at beginning of year | **$102,151** | $85,992 |
| Service cost | **523** | 581 |
| Interest cost | **6,561** | 6,662 |
| Actuarial loss | **4,363** | 13,435 |
| Benefits paid | **(4,427)** | (4,519) |
| Benefit obligation at end of year | **109,171** | 102,151 |
| **Change in plan assets** | | |
| Fair value of plan assets at beginning of year | **64,660** | 79,241 |
| Actual return on plan assets | **16,366** | (10,062) |
| Contributions | **12,611** | – |
| Benefits paid | **(4,427)** | (4,519) |
| Fair value of plan assets at end of year | **89,210** | 64,660 |
| Funded status | **(19,961)** | (37,491) |
| Unrecognized actuarial loss | **38,670** | 47,187 |
| Unrecognized prior service cost | **491** | 555 |
| Net amount recognized | **$19,200** | $10,251 |

The following amounts have been recognized in the Consolidated Balance Sheets:

| *In thousands* | Year Ended December 31, 2003 | 2002 |
|---|---|---|
| Accrued benefit liability | **$(18,370)** | $(34,185) |
| Intangible asset | **984** | 1,145 |
| Accumulated other comprehensive loss | **36,586** | 43,291 |
| Net amount recognized | **$19,200** | $10,251 |

The minimum pension liability included in other comprehensive income decreased $6.7 million during the year ended December 31, 2003, and increased $43.3 million during the year ended December 31, 2002.

The Company is not required to make and does not intend to make a contribution to either pension plan in 2004.

The following information is presented for pension plans with an accumulated benefit obligation in excess of plan assets:

| *In thousands* | December 31, 2003 | 2002 |
|---|---|---|
| Projected benefit obligation | **$109,171** | $102,151 |
| Accumulated benefit obligation | **107,580** | 98,844 |
| Fair value of plan assets | **$89,210** | $64,660 |

The Company's non-qualified, unfunded pension plan had an accumulated benefit obligation of $10.0 million and $8.9 million at December 31, 2003 and 2002, respectively.

Net pension cost for both plans included the following components:

| *In thousands* | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| Service cost | **$523** | $581 | $543 |
| Interest cost | **6,561** | 6,662 | 6,045 |
| Expected return on plan assets | **(5,964)** | (6,931) | (8,820) |
| Amortization of prior service cost | **65** | 65 | 65 |
| Recognized actuarial loss (gain) | **2,477** | 1,066 | 64 |
| Net periodic benefit cost (income) | **$3,662** | $1,443 | $(2,103) |

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

| *In thousands* | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| **Weighted-average assumptions used to determine net periodic benefit cost** | | | |
| 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% |

| | December 31, 2003 | 2002 |
|---|---|---|
| **Weighted-average assumptions used to determine benefit obligations** | | |
| Discount rate | **6.25%** | 6.85% |
| Rate of compensation increase | **4.00%** | 4.00% |

The discount rate assumptions are based on current yields of investment-grade corporate long-term bonds. The expected long-term return on plan assets is based on the expected future average annual return for each major asset class within the plan's portfolio (which is principally comprised of equity investments) over a long-term horizon. In determining the expected long-term rate of return on plan assets, the Company evaluated input from its investment consultants, actuaries, and investment management firms including their review of asset class return expectations, as well as long-term historical asset class returns. Projected returns by such consultants and economists are based on broad equity and bond indices. Additionally, the Company considered its historical 15-year compounded returns, which have been in excess of the Company's forward-looking return expectations.

The Company's funded pension plan assets as of December 31, 2003 and 2002, by asset category are as follows:

| *In thousands* | December 31, 2003 | 2002 |
|---|---|---|
| Equity securities | **$63,962** | $44,323 |
| Debt securities | **23,768** | 19,396 |
| Other | **1,480** | 941 |
| Total plan assets | **$89,210** | $64,660 |

The investment policy for the Harte-Hanks, Inc. Pension Plan focuses on the preservation and enhancement of the plan's assets through prudent asset allocation, quarterly monitoring and evaluation of investment results, and periodic meetings with investment managers.

The investment policy's goals and objectives are to meet or exceed the representative indices over a full market cycle (3-5 years). The policy establishes the following investment mix, which is intended to subject

the principal to an acceptable level of volatility while still meeting the desired return objectives.

| | Target | Acceptable Range | Benchmark Index |
|---|---|---|---|
| Domestic Equities | 55.0% | Range 35% to 75% | S&P 500 |
| Large Cap Growth | 22.5% | Range 15% to 30% | Russell 1000 Growth |
| Large Cap Value | 22.5% | Range 15% to 30% | Russell 1000 Value |
| Mid Cap Value | 10.0% | Range 5% to 15% | Russell Mid Cap Value |
| Domestic Fixed Income | 30.0% | Range 20% to 50% | LB Aggregate |
| International Equities | 15.0% | Range 10% to 25% | MSC1 EAFE |

To address the issue of risk, the investment policy places high priority on the preservation of the value of capital (in real terms) over a market cycle. Investments are made in companies with a minimum five-year operating history and sufficient trading volume to facilitate, under most market conditions, prompt sale without severe market effect. Investments are diversified; reasonable concentration in any one issue, issuer, industry or geographic area is allowed if the potential reward is worth the risk.

Investment managers are evaluated by the performance of the representative indices over a full market cycle for each class of assets. The Pension Plan Committee reviews, on a quarterly basis, the investment portfolio of each manager which includes rates of return, performance comparisons with the most appropriate indices, and comparisons of each manager's performance with a universe of other portfolio managers that employ the same investment style.

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 2003, 2002 and 2001 was $6.1 million, $6.4 million and $6.3 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 2,999,787 at December 31, 2003.

**Note G – Stockholders' Equity**

In January 2004, the Company announced an increase in the regular quarterly dividend from 3.0 cents per share to 4.0 cents per share, payable March 15, 2004 to holders of record on March 1, 2004.

During 2003 the Company repurchased 4.2 million shares of its common stock for $76.4 million under its stock repurchase program. In addition, the Company received 0.3 million shares of its common stock, with an estimated market value of $5.8 million, in exchange for proceeds related to stock option exercises. As of December 31, 2003 the Company has repurchased 35.7 million shares since the beginning of its stock repurchase program in January 1997. During this period the Company has also received 1.2 million shares in exchange for proceeds related to stock option exercises. Under this program, the Company had authorization to repurchase an additional 4.2 million shares at December 31, 2003.

**Note H – Stock Option Plans**

*1991 Plan*

The Company adopted the 1991 Stock Option Plan ("1991 Plan") pursuant to which it may issue to officers and key employees options to purchase up to 16,500,000 shares of common stock. Options have been granted at exercise prices equal to the market price of the common stock on the grant date ("market price options") and at exercise prices below market price of the common stock ("performance options"). As of December 31, 2003, 2002 and 2001, market price options to purchase 7,216,659 shares, 8,659,127 shares and 9,049,781 shares, respectively, were outstanding with exercise prices ranging from $4.25 to $21.23 per share at December 31, 2003. Market price options granted prior to January 1998 become exercisable after the fifth anniversary of their date of grant. Beginning January 1998, market price options generally become exercisable in 25% increments on the second, third, fourth and fifth anniversaries of their date of grant. The weighted-average exercise price for outstanding market price options and exercisable market price options at December 31, 2003 was $14.51 and $11.66, respectively. The weighted-average remaining life for outstanding market price options was 6.01 years.

At December 31, 2003, 2002 and 2001, performance options to purchase 161,325 shares, 359,625 shares and 751,875 shares, respectively, were outstanding with exercise prices ranging from $0.22 to $1.33 per share at December 31, 2003. 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, $0.1 million and $0.2 million was recognized for the performance options for the years ended December 31, 2003, 2002 and 2001, respectively. The weighted-average exercise price for outstanding performance options and exercisable performance options at December 31, 2003, was $0.62 and $0.51, respectively. The weighted-average remaining life for outstanding performance options was 2.61 years. The Company has not granted any performance options since 1999.

The following summarizes all stock option plans activity during 2003, 2002 and 2001:

| | Number Of Shares | Weighted Average Option Price |
|---|---|---|
| Options outstanding at January 1, 2001 | 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 |
| Granted | 318,300 | 18.04 |
| Exercised | (1,533,296) | 6.87 |
| Cancelled | (425,772) | 16.15 |
| Options outstanding at December 31, 2003 | 7,377,984 | $14.21 |
| Exercisable at December 31, 2003 | 3,516,478 | $11.32 |

The following table summarizes information about stock options outstanding at December 31, 2003:

| | 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 – 8.58 | 1,423,900 | 2.41 | $ 6.73 | 1,362,401 | $6.96 |
| $10.25 – 14.50 | 1,659,362 | 5.17 | $ 12.98 | 1,201,057 | $12.70 |
| $14.54 – 15.63 | 1,154,039 | 6.74 | $ 14.80 | 382,993 | $14.91 |
| $15.75 – 17.45 | 1,159,983 | 6.43 | $ 16.57 | 570,027 | $16.43 |
| $17.98 – 18.61 | 1,179,700 | 8.10 | $ 18.21 | – | – |
| $18.79 – 21.23 | 801,000 | 8.75 | $ 19.87 | – | – |
| | 7,377,984 | 5.94 | $ 14.21 | 3,516,478 | $11.32 |

The weighted-average fair value of market price options granted during 2003, 2002 and 2001 was $5.96, $6.75 and $5.35, respectively. The Company did not grant any performance options during 2003, 2002 or 2001.

**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 and trade payables.

**Note J – Commitments and Contingencies**

At December 31, 2003, the Company had outstanding letters of credit in the amount of $14.7 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 $29.2 million, $29.7 million and $28.5 million for the years ended December 31, 2003, 2002 and 2001, respectively.

Step rent provisions and escalation clauses, capital improvement funding, and other lease concessions are taken into account in computing the Company's minimum lease payments. The Company recognizes the minimum lease payments on a straight-line basis over the minimum lease term.

The future minimum rental commitments for all non-cancelable operating leases with terms in excess of one year as of December 31, 2003 are as follows:

| *In thousands* | |
|---|---|
| 2004 | $ 23,044 |
| 2005 | 17,595 |
| 2006 | 12,995 |
| 2007 | 9,914 |
| 2008 | 7,357 |
| After 2008 | 24,835 |
| | $ 95,740 |

### Note M – Selected Quarterly Data (Unaudited)

| *In thousands, except per share amounts* | 2003 Quarter Ended December 31 | September 30 | June 30 | March 31 | 2002 Quarter Ended December 31 | September 30 | June 30 | March 31 |
|---|---|---|---|---|---|---|---|---|
| Revenues | $ 255,721 | $ 239,366 | $ 233,169 | $ 216,320 | $ 239,525 | $ 226,466 | $ 227,879 | $ 214,907 |
| Operating income | 41,674 | 38,514 | 38,466 | 27,833 | 40,190 | 36,656 | 39,981 | 33,461 |
| Net income | 24,978 | 22,924 | 23,082 | 16,378 | 24,199 | 22,188 | 24,090 | 20,268 |
| Basic earnings per share | $ 0.29 | $ 0.26 | $ 0.26 | $ 0.18 | $ 0.27 | $ 0.24 | $ 0.26 | $ 0.22 |
| Diluted earnings per share | $ 0.28 | $ 0.26 | $ 0.26 | $ 0.18 | $ 0.26 | $ 0.24 | $ 0.25 | $ 0.21 |

### Note L – Earnings Per Share

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

| *In thousands* | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| **Basic EPS** | | | |
| Net income | $87,362 | $90,745 | $79,684 |
| Weighted-average common shares outstanding used in earnings per share computations | 88,541 | 92,648 | 94,808 |
| Earnings per share | $0.99 | $0.98 | $0.84 |
| **Diluted EPS** | | | |
| Net income | $87,362 | $90,745 | $79,684 |
| Shares used in diluted earnings per share computations | 89,982 | 94,872 | 97,174 |
| Earnings per share | $0.97 | $0.96 | $0.82 |
| **Computation of Shares Used in Earnings Per Share Computations** | | | |
| Average outstanding common shares | 88,541 | 92,648 | 94,808 |
| Average common equivalent shares — dilutive effect of option shares | 1,441 | 2,224 | 2,366 |
| Shares used in diluted earnings per share computations | 89,982 | 94,872 | 97,174 |

As of December 31, 2003, 2002 and 2001 the Company had approximately 56,000, 781,000 and 546,000 antidilutive market price options outstanding, respectively, which have been excluded from the EPS calculations.

### 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 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. The Company's Shoppers customers range from large national companies to local neighborhood businesses to individuals with a single item for sale. The segments core customers are local service businesses and small retailers. Shoppers' client base is entirely domestic.

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

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

| In thousands | 2003 | 2002 | 2001 |
|---|---|---|---|
| | Year Ended December 31, | | |
| **Revenues** | | | |
| Direct Marketing | **$584,804** | $573,826 | $601,901 |
| Shoppers | **359,772** | 334,951 | 316,027 |
| Total revenues | **$944,576** | $908,777 | $917,928 |
| **Operating income** | | | |
| Direct Marketing | **$76,641** | $83,872 | $85,020 |
| Shoppers | **78,007** | 74,564 | 63,398 |
| Corporate Activities | **(8,161)** | (8,148) | (8,788) |
| Total operating income | **$146,487** | $150,288 | $139,630 |
| **Income before income taxes** | | | |
| Operating income | **$146,487** | $150,288 | $139,630 |
| Interest expense | **(855)** | (1,208) | (3,076) |
| Interest income | **168** | 274 | 498 |
| Other, net | **(1,895)** | (2,004) | (4,614) |
| Total income before income taxes | **$143,905** | $147,350 | $132,438 |
| **Depreciation** | | | |
| Direct Marketing | **$23,908** | $27,088 | $26,769 |
| Shoppers | **5,493** | 5,008 | 5,235 |
| Corporate Activities | **32** | 32 | 75 |
| Total depreciation | **$29,433** | $32,128 | $32,079 |
| **Goodwill and intangible amortization** | | | |
| Direct Marketing | **$600** | $600 | $12,769 |
| Shoppers | **–** | – | 4,072 |
| Total goodwill and intangible amortization | **$600** | $600 | $16,841 |
| **Capital expenditures** | | | |
| Direct Marketing | **$18,526** | $12,782 | $22,354 |
| Shoppers | **13,365** | 4,548 | 4,085 |
| Corporate Activities | **24** | 28 | 6 |
| Total capital expenditures | **$31,915** | $17,358 | $26,445 |
| **Total assets** | | | |
| Direct Marketing | **$527,733** | $518,195 | |
| Shoppers | **188,301** | 180,109 | |
| Corporate Activities | **43,096** | 38,428 | |
| Total assets | **$759,130** | $736,732 | |
| **Goodwill** | | | |
| Direct Marketing | **$312,810** | $312,454 | |
| Shoppers | **124,346** | 124,346 | |
| Total goodwill | **$437,156** | $436,800 | |
| **Other intangible assets** | | | |
| Direct Marketing | **$2,667** | $3,267 | |
| Shoppers | **–** | – | |
| Total other intangible assets | **$2,667** | $3,267 | |

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

| In thousands | Year Ended December 31, 2003 | 2002 | 2001 |
|---|---|---|---|
| **Revenues** [a] | | | |
| United States | **$896,788** | $870,700 | $880,642 |
| Other countries | **47,788** | 38,077 | 37,286 |
| Total revenues | **$944,576** | $908,777 | $917,928 |
| **Long-lived net assets** [b] | | | |
| United States | **$89,733** | $86,324 | |
| Other countries | **8,014** | 7,830 | |
| Total long-lived assets | **$97,747** | $94,154 | |

a Geographic revenues are based on the location of the customer.

b Long-lived assets are based on physical location.

**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, 2003 and 2002, 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, 2003. 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, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003, 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 28, 2004

**CORPORATE INFORMATION**

**Common Stock**

The Company's common stock is listed on the New York Stock Exchange (NYSE) (symbol: HHS).

The reported high and low quarterly sales price ranges for 2003 and 2002 were as follows:

| | 2003 | | 2002 | |
|---|---|---|---|---|
| | High | Low | High | Low |
| First Quarter | **19.56** | **17.10** | 21.13 | 17.64 |
| Second Quarter | **19.65** | **17.19** | 22.68 | 19.29 |
| Third Quarter | **19.98** | **18.35** | 21.43 | 16.05 |
| Fourth Quarter | **22.15** | **18.41** | 20.38 | 17.45 |

In 2003, quarterly dividends were paid at the rate of 3.0 cents per share. 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.

There are approximately 2,900 holders of record.

**Transfer Agent and Registrar**
EquiServe Trust Company, N.A.
PO Box 43023
Providence, RI 02940-3023
(781) 575-4593
www.equiserve.com

**Annual Meeting of Stockholders**
The annual meeting of stockholders will be held at 10:00 a.m. on May 18, 2004, 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:

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

| *In thousands, except per share amounts* | 2003 | 2002 | 2001 | 2000 | 1999 |
|---|---|---|---|---|---|
| Statement of operations data | | | | | |
| Revenues | **$944,576** | $908,777 | $917,928 | $960,773 | $829,752 |
| Operating expenses | | | | | |
| Payroll, production and distribution | **687,738** | 649,539 | 649,552 | 686,502 | 606,676 |
| Advertising, selling, general and administrative | **80,318** | 76,222 | 79,826 | 92,330 | 70,060 |
| Depreciation | **29,433** | 32,128 | 32,079 | 28,494 | 24,126 |
| Goodwill and intangible amortization | **600** | 600 | 16,841 | 15,226 | 10,662 |
| Total operating expenses | **798,089** | 758,489 | 778,298 | 822,552 | 711,524 |
| Operating income | **146,487** | 150,288 | 139,630 | 138,221 | 118,228 |
| Interest expense, net | **687** | 934 | 2,578 | (384) | (5,313) |
| Net income | **87,362** | 90,745 | 79,684 | 81,886 | 72,941 |
| Earnings per common share—diluted | **0.97** | 0.96 | 0.82 | 0.78 | 0.67 |
| Cash dividends per common share | **0.12** | 0.10 | 0.08 | 0.07 | 0.05 |
| Weighted-average common and common equivalent shares outstanding—diluted | **89,982** | 94,872 | 97,174 | 104,480 | 108,216 |
| Adjusted data to exclude amortization of goodwill, net of tax effect [a] | | | | | |
| Net income | **87,362** | 90,745 | 91,700 | 92,638 | 80,707 |
| Earnings per common share—diluted | **0.97** | 0.96 | 0.94 | 0.89 | 0.75 |
| Segment data | | | | | |
| Revenues | | | | | |
| Direct Marketing | **584,804** | 573,826 | 601,901 | 662,044 | 559,262 |
| Shoppers | **359,772** | 334,951 | 316,027 | 298,729 | 270,490 |
| Total revenues | **$944,576** | $ 908,777 | $ 917,928 | $ 960,773 | $ 829,752 |
| Operating income | | | | | |
| Direct Marketing | **$76,641** | $ 83,872 | $ 85,020 | $ 91,450 | $ 79,164 |
| Shoppers | **78,007** | 74,564 | 63,398 | 55,710 | 47,015 |
| General corporate | **(8,161)** | (8,148) | (8,788) | (8,939) | (7,951) |
| Total operating income | **$146,487** | $150,288 | $139,630 | $138,221 | $118,228 |
| Operating income excluding amortization of goodwill [a] | | | | | |
| Direct Marketing | **$ 76,641** | $83,872 | $97,171 | $102,172 | $85,657 |
| Shoppers | **78,007** | 74,564 | 67,470 | 59,781 | 51,084 |
| General corporate | **(8,161)** | (8,148) | (8,788) | (8,939) | (7,951) |
| Total operating income | **$146,487** | $150,288 | $155,853 | $153,014 | $128,790 |
| Capital expenditures | **$31,915** | $17,358 | $26,445 | $36,465 | $28,928 |
| Balance sheet data (at end of period) | | | | | |
| Property, plant and equipment, net | **$97,747** | $94,154 | $109,428 | $112,065 | $106,250 |
| Goodwill and other intangibles, net | **439,823** | 440,067 | 438,325 | 439,148 | 409,791 |
| Total assets | **759,130** | 736,732 | 771,049 | 807,105 | 769,427 |
| Total long term debt | **5,000** | 16,300 | 48,312 | 65,370 | 5,000 |
| Total stockholders' equity | **$555,598** | $532,533 | $552,366 | $551,003 | $577,618 |

a. 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.

## DIRECTORS

**David L. Copeland**
President, SIPCO, Inc.

**William F. Farley**
Founder & Owner
Livingston Capital

**Dr. Peter T. Flawn**
President Emeritus
The University of Texas at Austin
Chairman, Audit Committee

**Larry Franklin**
Chairman

**William K. Gayden**
Chairman & Chief Executive Officer
Merit Energy Company

**Christopher M. Harte**
Private Investor
Chairman, Nominating & Corporate
Goverance Committee

**Houston H. Harte**
Vice Chairman

**Richard Hochhauser**
President & Chief Executive Officer

**James L. Johnson**
Chairman Emeritus
GTE Corporation
Chairman, Compensation Committee

**Judy C. Odom**
Private Investor
Co-Founder, Former Chairman
& Chief Executive Officer
Software Spectrum, Inc.

## OFFICERS

**Larry Franklin**
Chairman

**Richard Hochhauser**
President & Chief Executive Officer

**Dean Blythe**
Senior Vice President
& Chief Financial Officer

**Kathy Calta**
Senior Vice President, Direct Marketing

**James Davis**
Senior Vice President, Direct Marketing

**Bill Goldberg**
Senior Vice President, Direct Marketing

**Peter Gorman**
Senior Vice President, Shoppers

**Gary Skidmore**
Senior Vice President, Direct Marketing

**Bill Carman**
Vice President, Shoppers

**Robert J. Colucci**
Vice President, Direct Marketing

**Loren Dalton**
Vice President, Shoppers

**Carlos Guzman**
Vice President, Shoppers

**Steve Hacker**
Vice President, Legal & Secretary

**Frank Harvey**
Vice President, Direct Marketing

**Jessica Huff**
Vice President, Finance
& Chief Accounting Officer

**Spencer Joyner, Jr.**
Vice President, Direct Marketing

**Dave LaGreca**
Vice President, Direct Marketing

**Federico Ortiz**
Vice President, Tax

**Michael Paulsin**
Vice President, Shoppers

**Tann Tueller**
Vice President, Direct Marketing

## 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
Deerfield Beach, Florida
East Bridgewater, Massachusetts
Fort Worth, Texas
Fullerton, California
Glen Burnie, Maryland
Grand Prairie, Texas
Jacksonville, Florida
Lake Katrine, New York
Lake Mary, Florida
Langhorne, Pennsylvania
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
Westville, New Jersey
Wilkes-Barre, Pennsylvania

## NATIONAL SALES HEADQUARTERS

Cincinnati, Ohio

## INTERNATIONAL OFFICES

Stuttgart, 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

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