



# The Fundamentals of Customer Success

Harte-Hanks people have earned a reputation as trusted advisors because we help our clients achieve and exceed their marketing goals. We come to work every day with unsurpassed expertise and a zest for excellence. Grounded in the highest ethical standards, we live and breathe direct marketing and targeted media as science and art. We demonstrate our commitment to our clients by:

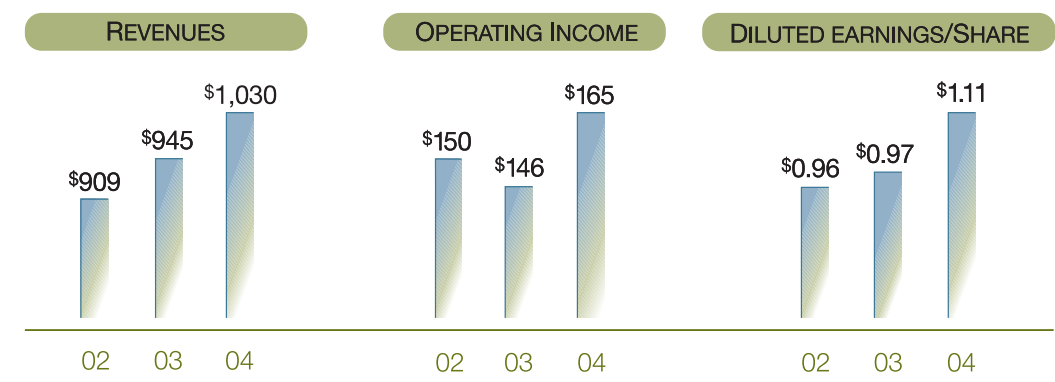
- Connecting businesses and individuals from highly diverse and dynamic demographic groups through our widely read, cost-effective shopper publications;
- Earning trust with our thorough, expert and candid review of each client's unique market situation;
- Applying our intimate knowledge of the benchmarks, regulations and industry standards that govern the client's vertical market;
- Developing and recommending integrated programs that exceed the client's return on investment (ROI) expectations;
- Executing programs for clients with the speed and efficiency made possible by our expertise and experience;
- Analyzing results to refine strategy in partnership with clients, to help them achieve success; and
- Making it simple for clients to satisfy all their direct and targeted marketing needs through a single point of contact.

This is how we do business. This is how we've set standards for the shoppers publishing and direct marketing fields. It's the way we crystallize the common carbon of marketing potential into the diamond of client success. This annual report is a summary of how we made it happen for our clients in 2004.



When the right customers actually decide to buy it, only when the right customers actually decide to buy it, only when the right customers actually decide to buy it, only when the right customers actually decide to buy it.

## Financial Highlights *(in millions, except per-share amount)*



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The people of Harte-Hanks succeed by creating success for our clients. No matter how great the potential of a product or service, its value is realized only when the right customers actually decide to buy it.



Nothing astonishes men so much as common sense and plain dealing. — Ralph Waldo Emerson

## Expertise Grounded in the Fundamentals

Originally a West Texas newspaper company founded in the 1920s, Harte-Hanks today is a leading worldwide direct marketing and targeted media company that offers direct marketing solutions and shopper advertising opportunities to a wide range of local, regional, national and international consumer and business-to-business marketers. Our success, and that of our clients, springs from our marketing mastery and its applications—with finesse gained from decades of experience and innovation.

Our two business lines, shopper publications and direct marketing, reflect where we excel. They also reflect the targeting needs of our global, national, regional and local clients. National firms, along with thousands of smaller retailers, service firms and individuals, use the effective audience targeting of our shopper publications in California and Florida. And from our 35 locations around the world, Harte-Hanks has built direct marketing partnerships with clients ranging from mid-sized to *Fortune 1000* companies across North America, Europe, South America and the Pacific Rim. These diverse corporations rely on Harte-Hanks for integrated communication programs that are targeted, created, produced, delivered, tracked, analyzed and refined by our vertical market experts.

Whether a client needs a complex multi-media program to launch a new pharmaceutical or a *PennySaver* ad to increase traffic at a local chain of restaurants, every service we perform is based on fundamental trust. How does Harte-Hanks earn that trust? With candor, transparency, expertise, efficiency and results. In each vertical market we serve, our teams of specialists earn our clients' respect by demonstrating unsurpassed knowledge and insight.

### Financial Highlights

(in thousands, except per share amount)

	2004	2003	2002
Revenues	\$ 1,030,461	\$ 944,576	\$ 908,777
Operating income	165,295	146,487	150,288
Depreciation and amortization	28,769	30,033	32,728
Interest expense	1,020	855	1,208
Net income	97,568	87,362	90,745
Diluted earnings per share <sup>1</sup>	1.11	0.97	0.96
Capital expenditures	35,146	31,915	17,358
Average common and common equivalent shares outstanding – diluted <sup>1</sup>	87,806	89,982	94,872

<sup>1</sup> 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.

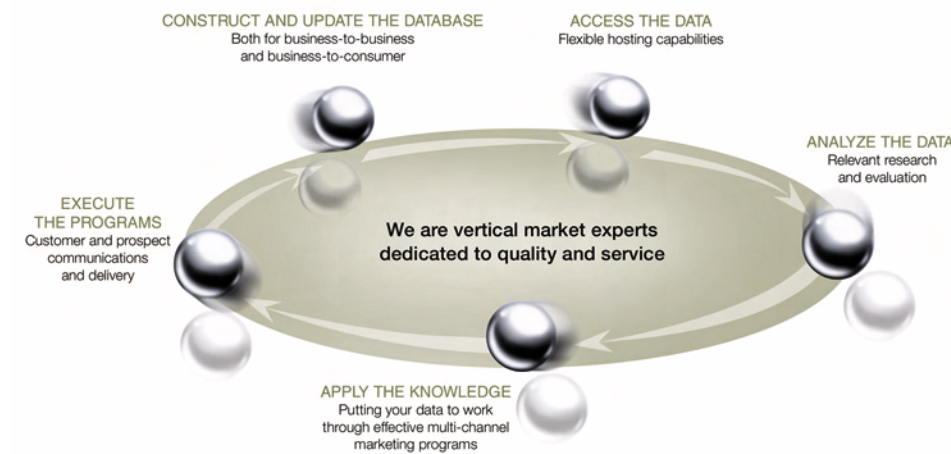


## Fundamentals of Harte-Hanks

### Direct Marketing

The range of Harte-Hanks Direct Marketing solutions can be conceptualized by our five fundamental solution points: Construct and update the database → Access the data → Analyze the data → Apply the knowledge → Execute the programs.

### Harte-Hanks Direct Marketing



At each point in this process, solutions are tailored by market for the client's evolving needs. Once the data-driven programs have been executed, their results are read, analyzed and applied to update the database and refine marketing programs. The knowledge gained enables the cycle to continue more effectively, achieving the strategic goal of the process—increasing the client's return on marketing investment.

This kind of end-to-end relationship is made easier by a true partnership with the client. We are candid with our clients, which facilitates the teamwork necessary to create and implement strategies that meet the challenges of today's markets.

### Shoppers

Harte-Hanks Shoppers is North America's largest owner, operator and distributor of shopper publications, with shoppers that are zoned into more than 900 separate editions with direct mail circulation in excess of 11 million in California and Florida each week.

A broad spectrum of residential advertisers and local, regional and national businesses depend on our publications for extremely cost-effective, flexible marketing. We target readers by geographic zone, or clusters of zones surrounding an advertiser location, and we apply demographic, language and lifestyle criteria for targeting. We offer advertisers not just a variety of print options, but also the opportunity to take advantage of interactive search functions in our online versions. Plus, our print publications receive the reliability, deliverability and

comprehensive coverage provided only by the United States Postal Service.

Always with an eye on the fundamentals, our Harte-Hanks shoppers business continues to set the bar for success in reaching and influencing targeted consumers.

### Harte-Hanks Shoppers





## Fundamental value delivery

The pressure to deliver value—better results at lower costs—has never been higher. We deliver value to our clients by doing the fundamentals better, by innovating, by understanding our clients and their vertical markets and buyers, and by providing a return on each client's marketing investments.

### Shoppers: value for clients

For our shopper publications, both in direct mail and online, our value offering gets delivered many ways. First, Harte-Hanks is vertically integrated as a shopper publisher: we sell, produce, and see the advertising through to delivery. We offer a range of ways for clients to advertise—in the book, in inserts, on Web sites and with detached cards. We offer a variety of placement options and formats, such as front cover, back cover and in color. We target with average circulations of approximately 12,000, and we enable sub-zone inserts. Plus, we accept advertising within as few as three business days prior to delivery.

Our *PennySaver* and *Flyer* titles are highly recognized, powerful brands in their communities. Audited readership consistently places us among the most highly read publications. Our impact is measured right at the client's cash register. We saturate in areas of coverage—reaching nearly everyone in the targeted geography. No other print publication achieves this mark at our level of circulation. It's a 40-year formula that, with innovation, continues to produce results even as we invest to ensure tomorrow's success.

### Direct Marketing: value for clients

It takes highly skilled professionals equipped with the best tools to transform disparate customer data into patterns that prompt smart marketing action.

Let's examine the five integrated solution points of direct marketing in more detail:

### Constructing and updating the database

To influence future purchase behavior, a marketer must understand previous purchase behavior—what, how, when and at what price people buy. Companies that need to know partner with Harte-Hanks for our world-class technology and people. Data are gathered, stored, verified, cleansed, enhanced and organized into an accessible repository.

Three examples of Harte-Hanks leadership in data technology and services are our Advanced Data Quality (ADQ) offering for customer/prospect contact information quality; a proprietary component of ADQ, the Trillium Software System®; and the CI Technology Database for business market intelligence.

### Accessing the data

Once the database is built, the information it contains has value only to the extent that it can be accessed to solve business problems and improve marketing cost-effectiveness.

Premier among the industry's tools to enable more smart, strategic and cost-effective direct marketing is our range of vertically focused Allink® solutions. The Allink suite of products and services is based on more than 30 years of successful database construction, and consists of fully relational, Web-based, privacy-compliant, operational and analytic customer-management systems.

Our *nexTouch* suite enables marketers to manage leads and subsequent prospect and customer "touch points" in database-driven multichannel communications. We provide Web-based support for online meetings and event management, order processing, customer care, tech support/help desk and fulfillment.

### Analyzing the data

Our consultants, researchers, modelers and analysts provide consultation, campaign support, segmentation and modeling that are data-based, analysis-driven and grounded in a sophisticated understanding of direct marketing, customer relationship management and vertical markets. Our analytics professionals improve the effectiveness of marketing efforts by translating data into information and information into knowledge. That enables them to identify likely responders.

### Applying the knowledge

Our expertise allows us to put knowledge to work in customer acquisition and retention; cross-sell, up-sell and loyalty programs; privacy initiatives; customer-care services; merger and acquisition communications; sales and lead-management systems; and company-specific promotional campaigns. Our agency team provides both the strategic and creative insights to design award-winning and results-driven campaigns to capitalize on this extracted knowledge.

### Executing the programs

Our front-line vertical implementation teams help deliver personalized mail campaigns, on-demand production, fulfillment (electronic and traditional), e-mail programs, teleservices, Web site development and support, and logistics.

As one of the largest and most focused providers in each of these areas, we implement each step with the ultimate aim of increasing client growth and ROI.

## Fundamental Goals

Underlying everything we do is the goal of exceeding the expectations of each customer. That's the way we define success. Our fundamental values, attitudes, philosophy and style are at the root of the Harte-Hanks insight, expertise and productivity that enable our customers to achieve *their* goals. Harte-Hanks employees respond proactively and flexibly to opportunities and challenges. And we accept individual responsibility for doing the right things and doing them right.

We value:

- Mutual trust and candor;
- Respect, teamwork and a strong work ethic;
- Pride and excellence;
- A willingness to take risks, to change and to grow;
- An emphasis on action and a sense of urgency toward our goals; and
- A spirit of fun in our work.

The people of Harte-Hanks place the highest value on our responsibilities to our customers and stakeholders. By conducting business ethically, we fulfill our commitment to help the communities we serve and to help lead our industry.



We can never be satisfied or complacent, because today's "standard" always has proven to become tomorrow's "price of entry." — Richard Hochhauser



## Fundamental Results



We started the year with momentum in both our Direct Marketing and Shoppers businesses, yet much needed to be accomplished for 2004 to achieve its potential as a growth year. This letter describes, in brief, the many achievements of Harte-Hanks in what turned out to be a very exciting year.

*The quality of a person's life is in direct proportion to their commitment to excellence, regardless of their chosen field of endeavor. — Vice Lombardi*

We see two components in delivering “The Fundamentals of Customer Success.” First is moving our clients from a good place to a better one—with the help of Harte-Hanks. And second is the underlying culture of Harte-Hanks, which facilitates the results we deliver for our clients. We take much pride in both, and each component differentiates us.

We continued to perform solidly in Shoppers and laid the groundwork for sustaining this trend. We extended our growth streak in this business to eight years. We posted solid revenue and profit growth, as we built circulation and enhanced our publications. In Direct Marketing, revenue continued to grow, and each of our vertical markets experienced growth. We translated this increased revenue into profits—our return on sales gained ground. We said that this would be a focus for us this year, and we made it happen.

In 2004, our diluted earnings per share increased to \$1.11 on revenues of \$1.03 billion—the first time Harte-Hanks has surpassed the billion-dollar revenue mark. Direct Marketing, which comprised 62% of total revenue, achieved all of the key financial metric goals that we established for this business. We continued positive revenue momentum—posting a 9.6% revenue gain—at the same time we drove up profit percentages. Shoppers performance generated revenue growth of 8.2% and operating income posted a 10.1% increase. This achievement is particularly noteworthy in that paper costs ended 2004 at their highest point in three years.

We continued to evaluate numerous acquisition opportunities and acted upon three small ones—all strategic. In February, we purchased Avellino

Technologies Ltd., a leading provider of data profiling technology. We have fully integrated its Discovery software into the Trillium Software System® and now have a more complete offering. In December, we acquired Postfuture, an e-mail marketing company, which offers us many opportunities to integrate e-mail more fully into true multichannel programs for our clients. In Shoppers, we acquired a shopper publication in the fast-growing Hemet, California area and integrated the publication with our *PennySaver* brand.

Other uses of capital included the repurchase of approximately 3.6 million shares during 2004, making a total of approximately 39.3 million shares repurchased since the company initiated this activity in 1997. During the year, the board authorized an increase of five million additional shares for buyback, making the year-end total of approximately 5.6 million shares available for repurchase through this program. We also invested in a range of client-focused software, hardware and equipment aimed at creating new revenue opportunities. In total, we spent \$35.1 million on capital projects in 2004.

We made some significant changes among company officers throughout Harte-Hanks. On our Direct Marketing team, Kathy Calta, Jim Davis and Bill Goldberg were promoted to senior vice president and Robert Colucci, Frank Harvey and Dave LaGreca were made vice presidents. In the corporate office, Steve Hacker was hired as vice president, legal and secretary.

Shoppers achieved much in 2004:

- Significant circulation growth in contiguous expansion of approximately 600,000;
- Improved customer service via Internet-based technology for primary accounts;
- Programming mostly completed on a major common systems project that supports multi-unit advertising, market pricing, common billing, and media scheduling;
- Introduction of new shopper insert packages including *Local Living* and *Pensando en Ti*; and
- Improved readership, based on independent survey research.

And in 2004, among our accomplishments in Direct Marketing were:

- Revenue growth in all vertical markets;
- Improved margin;
- Expanded number of facilities, while others were consolidated;
- A gain in awareness, recognition and client base in our Allink® database offerings; and
- A number of prestigious awards. Among them Trillium Software® receiving the highest score awarded for customer satisfaction among data quality vendors in *Customer Relationship Management* magazine, as well as tops in market share according to Forrester. Harte-Hanks was chosen by Microsoft as one of its six top vendors, and its best for customer service, noting that Harte-Hanks has “come to be regarded as an indispensable contributor to Microsoft.”

During the year, we celebrated the 25th anniversary of Forum, our Direct Marketing customer event held both in New York and in San Francisco. Our 2004 theme was “Defying Gravity: Customer Growth Under Pressure.”

For our more than 7,000 employees, we launched an internal Online Learning Center to provide for more uniform employee training, and a way for professionals in the company to communicate more easily with peers across locations using an intranet. The OLC complements prior continuing employee education initiatives. We also are in the process of implementing a newly acquired human capital management system to aid in numerous workplace management activities.

In 2004, we also developed and posted corporate governance policies and notices, approved by the Board of Directors, as we prepared to meet new federal Sarbanes-Oxley Act financial reporting and New York Stock Exchange listing requirements. These policies and notices pertained to audits, business practice, ethics, executive compensation, nominations to the Board of Directors and shareholder communication.

These “corporate governance” policies are posted plainly on our Web site home page. Regarding Sarbanes-Oxley, I am pleased to say that management has completed its assessment of internal controls over financial reporting as required by Section 404, and neither we nor our independent auditor, KPMG LLP, have identified any material weaknesses. Accordingly, our external auditor has concluded that our internal control over financial reporting is effective.

These achievements collectively reflect our energy, our culture, our vision and our dedication to customer success. Fundamentally, the people of Harte-Hanks are special; they made it happen in 2004.

Richard Hochhauser



Richard Hochhauser  
President & Chief Executive Officer







I know the price of success: dedication, hard work, and an unrelenting devotion to the things you want to see happen. — Frank Lloyd Wright

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

### Overview

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. The Company manages its operations through two operating segments: Direct Marketing and Shoppers.

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. The services and software products offered by Direct Marketing are tailored to specific industries or markets. In 2004, revenue from the Direct Marketing segment represented 62% of the Company's total revenue.

Harte-Hanks Shoppers is North America's largest owner, operator and distributor of shopper publications, based on weekly circulation and revenues. Shoppers are weekly advertising publications delivered free by Standard Mail to households and businesses in a particular geographic area. As of December 31, 2004, the Company's shoppers are zoned into 952 separate editions with total circulation of more than 11 million in California and Florida each week. In 2004, revenue from the Shoppers segment represented 38% of the Company's total revenue.

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 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

Operating results were as follows:

<i>In thousands</i>	2004	% Change	2003	% Change	2002
Revenues	\$1,030,461	9.1	\$ 944,576	3.9	\$ 908,777
Operating expenses	865,166	8.4	798,089	5.2	758,489
Operating income	\$ 165,295	12.8	\$ 146,487	-2.5	\$ 150,288

Consolidated revenues increased 9.1%, to \$1,030.5 million, while operating income increased 12.8%, to \$165.3 million, in 2004 compared to 2003. Overall operating expenses increased 8.4% to \$865.2 million. The Company's overall results reflect revenue increases in both its Direct Marketing and Shoppers segments. Increases in operating income in the Company's Direct Marketing and Shoppers segments were partially offset by increased general corporate operating expenses.

The Company's overall 2003 results reflect increased revenue from its Direct Marketing and Shoppers segments, and an operating income decrease from the Direct Marketing segment, partially offset by increased operating income from the Shoppers segment.

### Direct Marketing

Direct Marketing operating results were as follows:

<i>In thousands</i>	2004	% Change	2003	% Change	2002
Revenues	\$ 641,214	9.6	\$ 584,804	1.9	\$ 573,826
Operating expenses	550,358	8.3	508,163	3.7	489,954
Operating income	\$ 90,856	18.5	\$ 76,641	-8.6	\$ 83,872

Direct Marketing revenues increased \$56.4 million, or 9.6%, in 2004 compared to 2003. These results reflect increased revenues in all of the Company's vertical markets. Revenues from the high-tech/telecom and pharmaceutical/healthcare vertical markets had double-digit growth in 2004 compared to 2003. Revenues from the financial services vertical market increased near double-digits in 2004 compared to 2003. Revenues from the retail vertical market, Direct Marketing's largest vertical market in terms of annual revenue, were up in the mid-single digits. The company's select markets group also experienced mid-single digit growth in 2004 over 2003, with the majority of the growth coming from the manufacturing and business services industries.

From a service offering perspective, Direct Marketing experienced increased revenues from customer care, analytics, software, fulfillment, logistics, targeted mail, telesales and agency-related business.

The Company has not seen any material change in the competitive landscape during 2004. Revenues from the Company's vertical markets are impacted by the economic fundamentals of each vertical market as well as the financial condition of specific customers.

Operating expenses increased \$42.2 million, or 8.3%, in 2004 compared to 2003. Labor costs increased \$28.7 million, or

11.4%, as a result of increased incentive compensation due to Direct Marketing's financial performance, higher payroll costs due to higher volumes and increased headcount, and higher unemployment taxes. Labor costs were partially offset by lower healthcare costs and pension expense. Production and distribution costs increased \$13.1 million, or 6.9%, primarily due to higher logistics-related transportation costs, outsourcing costs, and production services expense, which were partially offset by decreased lease expense. General and administrative expenses increased \$1.8 million, or 4.3%, due to increased insurance expense, employee expense, and bad debt expense, partially offset by decreased royalties and professional services. Depreciation and amortization expense decreased \$1.4 million, or 5.7%, due to lower capital expenditures starting in 2001 and continuing into 2002 and assets becoming fully depreciated. Direct Marketing's largest cost component is labor, and these costs are primarily variable and tend to fluctuate with revenues and the demand for the Company's Direct Marketing services. Although total Company healthcare costs decreased in 2004, healthcare costs in general are expected to continue to increase, and this increase is likely to impact Direct Marketing's total labor costs and total operating expenses.

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 a 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 had double-digit growth in 2003 compared to 2002. The company's select market group also had double-digit growth for the year over 2002, particularly from the government/non-profit and manufacturing sectors. Revenues from the pharmaceutical/healthcare vertical market were flat in 2003 compared to 2002. Revenues from the retail vertical market, Direct Marketing's largest vertical market in terms of annual revenue, were down compared to 2002. Revenues from the financial services vertical market were also down in 2003 compared to 2002.

### Shoppers

Shoppers operating results were as follows:

<i>In thousands</i>	2004	% Change	2003	% Change	2002
Revenues	\$ 389,247	8.2	\$ 359,772	7.4	\$ 334,951
Operating expenses	303,390	7.7	281,765	8.2	260,387
Operating income	\$ 85,857	10.1	\$ 78,007	4.6	\$ 74,564

Shoppers revenues increased \$29.5 million, or 8.2%, in 2004 compared to 2003. Revenue increases were the result of improved sales in established markets and geographic expansions into new neighborhoods in California and Florida. Total Shoppers circulation increased by approximately 600,000 during 2004 and at December 31, 2004, Shoppers circulation reached more than 11 million (including 240,000 in South Orange County, California, where Shoppers publishes two editions each week). During the year, the Harte-Hanks Shoppers *PennySaver* publication in Northern California expanded circulation by 323,500. The Harte-Hanks Shoppers *PennySaver* publication in Southern California increased geographic coverage by adding 150,000 circulation. The Harte-Hanks Shoppers publication *The Flyer*, located in South Florida, expanded geographically by 129,500 circulation. The Company believes that expansions provide increased revenue opportunities and plans to cover an additional circulation of approximately 1.1 million over the next three 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, and its distribution

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

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.

products. These increases were partially offset by decreased coupon book revenues.

Shoppers operating expenses rose \$21.6 million, or 7.7%, in 2004 compared to 2003. Labor costs increased \$6.3 million, or 6.2%, due to higher payroll costs as a result of higher volumes and circulation expansions, and higher unemployment taxes, partially offset by lower pension and health care expense. Production costs increased \$13.8 million, or 9.6%, including additional postage of \$6.6 million due to increased volumes, and increased paper costs due to increased volumes and rates. General and administrative costs increased \$1.4 million, or 4.4%, due to increased business services and bad debt expense, partially offset by decreased promotion expense. Depreciation expense increased \$0.1 million, or 2.3%, due to new capital investments to support future growth. Shoppers' largest cost components are labor, postage and paper. Shoppers' labor costs are variable and tend to fluctuate with the number of zones, circulation, volumes and revenues. Although total Company healthcare costs decreased in 2004, healthcare costs in general are expected to continue to increase, and this increase is likely to impact Shoppers' total labor costs and total operating expenses. Standard postage rates have been unchanged since the beginning of the third quarter of 2002, and it is anticipated that the next increase in postage rates will occur in 2006. Increased postage rates would impact Shoppers' total production costs.



Newsprint prices increased throughout 2004 and are expected to continue to increase in 2005, which will impact Shoppers' total production costs in 2005 and 2006.

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 during 2003, and at December 31, 2003, Shoppers circulation reached approximately 10.5 million (including 220,000 in South Orange County, California, where Shoppers publishes two editions each week).

From a product-line perspective, Shoppers had growth in both ROP 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.

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 in the first half of 2003 than in the first half of 2002, and increased volumes 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 affected by the move into the new facility in Northern California and the once every six year occurrence of one extra publication week in 2003.

#### General Corporate Expense

General corporate operating expense increased \$3.3 million, or 39.9%, to \$11.4 million in 2004 compared to 2003. The increase in general corporate expense in 2004 was primarily a result of increased incentive compensation due to the Company's financial performance and increased professional services.

#### Interest Expense/Interest Income

Interest expense increased \$0.2 million in 2004 over 2003, due primarily to higher interest rates. Interest expense decreased \$0.4 million in 2003 over 2002, primarily due 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. The Company's debt at December 31, 2004 and 2003 is described in Note C of the "Notes to Consolidated Financial Statements," included herein.

Interest income increased \$0.2 million in 2004 compared to 2003, primarily due to interest related to a tax refund the Company received in the first quarter of 2004. Interest income decreased \$0.1 million in 2003 compared to 2002, primarily due to lower interest rates and lower average investment balances in 2003 compared to 2002.

#### Other Income and Expense

Other net expense for 2004 and 2003 primarily consists of balance-based bank charges and stockholders expenses.

#### Income Taxes

Income taxes increased \$8.9 million in 2004 and decreased \$0.1 million in 2003, primarily due to the respective changes in income levels. The effective income tax rate was 40.1%, 39.3% and 38.4% in 2004, 2003 and 2002, respectively. The effective income tax rate calculated is higher than the federal statutory rate of 35%, due to the addition of state taxes.

#### Acquisitions

As described in Note B of the "Notes to Consolidated Financial Statements" included herein, the Company made three acquisitions in 2004.

In December 2004, the Company acquired Postfuture, Inc., an e-mail service provider located in Richardson, Texas, that provides both e-mail technology and services, among them a platform that automates campaign and transactional e-mail delivery to support e-commerce, customer service, event communication and lead nurturing. Postfuture's offerings are being integrated into several existing Harte-Hanks solution offerings, including Allink on Demand®, CI Technology Database and Allink Agent®, among others.

In April 2004, Harte-Hanks acquired *Dollar Saver*, a local shopper publication in the fast-growing Hemet area in Southern California, and converted it to the *PennySaver* brand.

In February 2004, Harte-Hanks acquired Avellino Technologies Ltd., a leading provider of data profiling technology. Harte-Hanks has integrated Trillium Software System® and the Avellino Discovery software solution. Joining these two solutions allows organizations to take advantage, for the first time, of a single solutions provider to define, assess, improve and monitor the utility of data for their business processes. Harte-Hanks still offers Trillium Software and Avellino Discovery as stand-alone products as well as an integrated solution within the Trillium Software System. Founded in 1997, Avellino Technologies Ltd. is located in Aldermaston, UK.

The Company did not make any acquisitions in 2003 or 2002.

#### Liquidity and Capital Resources

Cash provided by operating activities for 2004 was \$153.3 million, a \$29.3 million increase compared to 2003. The increase in 2004 primarily relates to an increase in net income and an increase in other accrued expenses, income taxes and payroll at December 31, 2004 over December 31, 2003. In

addition, the Company made a \$12.6 million pension plan funding payment in 2003.

Net cash outflows from investing activities were \$64.6 million for 2004, compared to net cash outflows of \$31.6 million in 2003. The increase in 2004 primarily relates to a higher amount spent on acquisitions and capital investments in 2004 than in 2003.

Net cash used in investing activities for 2004 included \$35.1 million for capital expenditures and \$29.7 million for acquisitions. The Direct Marketing segment's capital expenditures consisted primarily of product development and enhancement, additional computer capacity, computer and communication systems and equipment upgrades. The Shoppers segment's capital expenditures were primarily related to the Southern California color capacity expansion, common system software, additional computers and other production equipment. \$28.0 million of the acquisition-related payments were made in the Direct Marketing segment, and the remaining \$1.7 million were made in the Shoppers segment.

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 Shoppers 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 acquisitions completed prior to 2003, were made in the Direct Marketing segment.

Net cash outflows from financing activities in 2004 were \$82.1 million, compared to \$85.3 million in 2003. The decrease in 2004 primarily relates to \$5.0 million net borrowings compared to \$11.3 million net repayment of debt in 2003. This was partially offset by a higher amount spent repurchasing stock in 2004 than in 2003.

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. The Company intends to secure new financing prior to this date.

Management considers such factors as current assets, current liabilities, total debt, revenues, operating income and cash flows from operations, investing activities and financing activities when assessing the Company's liquidity.

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, 2004, the Company had \$115.0 million of unused borrowing capacity under its credit facility.

The Company's contractual obligations at December 31, 2004 are as follows:

<i>In thousands</i>	Total	2005	2006	2007	2008	2009	Thereafter
Debt .....	\$ 10,000	\$ 10,000	\$ —	\$ —	\$ —	\$ —	\$ —
Operating leases .....	88,002	22,372	17,359	14,260	9,968	7,322	16,721
Deferred compensation liability .....	6,820	650	650	650	623	600	3,647
Other long-term obligations .....	8,052	3,708	2,832	1,506	4	2	—
Total contractual cash obligations .....	\$ 112,874	\$ 36,730	\$ 20,841	\$ 16,416	\$ 10,595	\$ 7,924	\$ 20,368

At December 31, 2004, the Company had outstanding letters of credit in the amount of \$20.3 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, 2004.

The company paid a quarterly dividend of \$0.04 per common share and \$0.03 per common share in each of the quarters in the years ended December 31, 2004 and 2003, respectively.

During 2004 the Company repurchased approximately 3.6 million shares of its common stock for \$85.7 million under its stock repurchase program. In addition, the Company received approximately 0.2 million shares of its common stock, with an

estimated market value of \$4.3 million, in exchange for proceeds related to stock option exercises. As of December 31, 2004, the Company has repurchased approximately 39.3 million shares since the beginning of its stock repurchase program in January 1997. During this period the Company has also received approximately 1.3 million shares in exchange for proceeds related to stock option exercises. Under this program, the Company had authorization to repurchase approximately 5.6 million additional shares at December 31, 2004.

#### 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 at 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 5% of total Harte-Hanks revenue for the years ended December 31, 2004, 2003 and 2002.

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

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

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

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

Revenue from market research and analytical services may be billed based on hourly rates or at 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 post-contract 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.

Shoppers 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 \$3.0 million, \$1.6 million and \$1.2 million for the years ended December 31, 2004, 2003 and 2002, 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 individual 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 claims. 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, 2004, earnings would be impacted by up to \$815,000, 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, 2004. 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, 2004 and 2003, the Company’s goodwill balance was \$458.2 million, net of \$82.0 million of accumulated amortization, and \$437.2 million, net of \$82.0 million of accumulated amortization, respectively. Based upon the Company’s analysis, the estimated fair values of the Company’s reporting units as of December 31, 2004 was well in excess of the reporting units’ carrying values.

#### **Factors That May Affect Future Results and Financial Condition**

From time to time, in both written reports and oral statements by senior management, the Company may express its expectations regarding its future performance. These “forward-looking statements” are inherently uncertain, and investors should realize that events could turn out to be other than what senior management expected. Set forth below are some key factors that could affect the Company’s future performance, including its revenues, net income and earnings per share; 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, Judicial Interpretations, Consumer Environment*

There could be a material adverse impact on the Company's business due to the enactment of legislation or industry regulations, the issuance of judicial interpretations, or simply a change in customs, arising from public concern over consumer privacy issues. Restrictions could be placed upon the collection, management, aggregation and use of information that is legally available, which could result in a material increase in the cost of collecting some kinds of data. It is also possible that we could be prohibited from collecting or disseminating certain types of data, which could in turn materially adversely affect our ability to meet our clients' requirements.

### *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 additional legislation is passed restricting the use of the data.

### *Acquisitions*

The Company continues to pursue acquisition opportunities. Acquisition activities, even if not consummated, require substantial amounts of management time and can distract from normal operations. In addition, there can be no assurance that the synergies and other objectives sought in acquisitions would be achieved. The Company believes that it will be able to successfully integrate recently acquired businesses into existing operations, but there is no certainty that future acquisitions will be consummated on acceptable terms or that any acquired assets, data or businesses will be successfully integrated into the Company's operations. The failure to identify appropriate candidates, to negotiate favorable terms, or to successfully integrate future acquisitions into existing operations could result in decreased revenues, net income and earnings per share.

### *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 Shoppers 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, other communications media and other advertising printers 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 have been unchanged since the beginning of the third quarter of 2002, and it is anticipated the next increase in postage rates will occur in 2006. Overall Shoppers postage costs are expected to grow 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 Shoppers 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 Shoppers 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 economies.

### *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.

### *International Operations*

Harte-Hanks Direct Marketing conducts business outside of the United States. During 2004, approximately 8.8% of Harte-Hanks Direct Marketing's revenues was derived from business outside the United States. Accordingly, the Company's future operating results could be negatively affected by a variety of factors, some of which are beyond its control. In addition, exchange rate movements may have an impact on the Company's future costs or on future cash flows from foreign investments. The Company has not entered into any foreign currency forward exchange contracts or other derivative instruments to hedge the effects of adverse fluctuations in foreign currency exchange rates. Additional risks inherent in the Company's non-U.S. business activities generally include, among others, potentially longer accounts receivable payment cycles, the costs and difficulties of managing international operations, potentially adverse tax consequences, and greater difficulty enforcing intellectual property rights. The various risks that are inherent in doing business in the United States are also generally applicable to doing business outside of the United States, and may be exaggerated by the difficulty of doing business in numerous sovereign jurisdictions due to differences in culture, laws and regulations.

### *War*

War and/or terrorism or the threat of war and/or terrorism 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.



Harte-Hanks, Inc. and Subsidiaries Consolidated Balance Sheets

December 31,

<i>In thousands, except per share and share amounts</i>	2004	2003
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents .....	\$ 38,807	\$ 32,151
Accounts receivable (less allowance for doubtful accounts of \$1,892 in 2004 and \$1,240 in 2003) .....	168,755	152,703
Inventory .....	6,086	5,213
Prepaid expenses .....	16,664	13,816
Deferred income tax asset .....	13,812	7,682
Other current assets .....	6,373	5,732
Total current assets .....	<u>250,497</u>	<u>217,297</u>
Property, plant and equipment		
Land .....	3,463	3,423
Buildings and improvements .....	37,312	36,817
Software .....	76,347	62,955
Equipment and furniture .....	190,522	183,744
	<u>307,644</u>	<u>286,939</u>
Less accumulated depreciation and amortization .....	<u>(204,669)</u>	<u>(194,987)</u>
	102,975	91,952
Software development and equipment installations in progress .....	10,795	5,795
Net property, plant and equipment .....	<u>113,770</u>	<u>97,747</u>
Intangible and other assets		
Goodwill (less accumulated amortization of \$81,973 in 2004 and 2003) .....	458,171	437,156
Other intangible assets (less accumulated amortization of \$2,933 in 2004 and \$2,333 in 2003) .....	2,067	2,667
Other assets .....	3,848	4,263
Total intangible and other assets .....	<u>464,086</u>	<u>444,086</u>
Total assets .....	<u>\$ 828,353</u>	<u>\$ 759,130</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Current maturities of long-term debt .....	\$ 10,000	\$ —
Accounts payable .....	55,632	47,891
Accrued payroll and related expenses .....	36,539	22,808
Customer deposits and unearned revenue .....	53,707	48,658
Income taxes payable .....	17,239	7,776
Other current liabilities .....	9,075	6,939
Total current liabilities .....	<u>182,192</u>	<u>134,072</u>
Long-term debt .....	—	5,000
Other long-term liabilities (including deferred income taxes of \$48,201 in 2004 and \$35,853 in 2003) .....	74,362	64,460
Total liabilities .....	<u>256,554</u>	<u>203,532</u>
Stockholders' equity		
Common stock, \$1 par value, authorized: 250,000,000 shares Issued 2004: 114,505,329; issued 2003: 113,280,794 shares .....	114,505	113,281
Additional paid-in capital .....	253,515	235,996
Retained earnings .....	882,750	798,974
Less treasury stock, 2004: 29,524,064; 2003: 25,788,502 shares at cost .....	(663,779)	(573,863)
Accumulated other comprehensive loss .....	(15,192)	(18,790)
Total stockholders' equity .....	<u>571,799</u>	<u>555,598</u>
Total liabilities and stockholders' equity .....	<u>\$ 828,353</u>	<u>\$ 759,130</u>

See Notes to Consolidated Financial Statements.

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

Year Ended December 31,

<i>In thousands, except per share amounts</i>	2004	2003	2002
Revenues .....	\$ 1,030,461	\$ 944,576	\$ 908,777
Operating expenses			
Payroll .....	394,417	357,811	340,703
Production and distribution .....	361,298	334,359	311,540
Advertising, selling, general and administrative .....	80,682	75,886	73,518
Depreciation .....	28,169	29,433	32,128
Intangible amortization .....	600	600	600
Total operating expenses .....	<u>865,166</u>	<u>798,089</u>	<u>758,489</u>
Operating income .....	165,295	146,487	150,288
Other expenses (income)			
Interest expense .....	1,020	855	1,208
Interest income .....	(341)	(168)	(274)
Other, net .....	1,648	1,895	2,004
	<u>2,327</u>	<u>2,582</u>	<u>2,938</u>
Income before income taxes .....	162,968	143,905	147,350
Income tax expense .....	65,400	56,543	56,605
Net income .....	<u>\$ 97,568</u>	<u>\$ 87,362</u>	<u>\$ 90,745</u>
Basic earnings per common share .....	\$ 1.13	\$ 0.99	\$ 0.98
Weighted-average common shares outstanding .....	86,169	88,541	92,648
Diluted earnings per common share .....	\$ 1.11	\$ 0.97	\$ 0.96
Weighted-average common and common equivalent shares outstanding .....	<u>87,806</u>	<u>89,982</u>	<u>94,872</u>

See Notes to Consolidated Financial Statements.

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

Year Ended December 31,

<i>In thousands</i>	2004	2003	2002
<b>Cash Flows from Operating Activities</b>			
Net income .....	\$ 97,568	\$ 87,362	\$ 90,745
Adjustments to reconcile net income to net cash provided by operations:			
Depreciation .....	28,169	29,433	32,128
Intangible amortization .....	600	600	600
Amortization of option-related compensation .....	101	100	99
Deferred income taxes.....	6,963	12,047	8,878
Other, net.....	534	379	741
Changes in operating assets and liabilities, net of effects from acquisitions and divestitures:			
(Increase) decrease in accounts receivable, net .....	(14,215)	(15,024)	730
(Increase) decrease in inventory .....	(873)	86	536
(Increase) decrease in prepaid expenses and other current assets .....	(3,233)	2,931	(2,762)
Increase (decrease) in accounts payable.....	7,442	7,145	(2,244)
Increase in other accrued expenses and other liabilities .....	26,232	7,186	8,884
Other, net.....	4,029	(8,181)	3,302
Net cash provided by operating activities .....	<u>153,317</u>	<u>124,064</u>	<u>141,637</u>
<b>Cash Flows from Investing Activities</b>			
Acquisitions .....	(29,705)	(343)	(3,791)
Purchases of property, plant and equipment .....	(35,146)	(31,915)	(17,358)
Proceeds from the sale of property, plant and equipment .....	268	621	439
Net cash used in investing activities .....	<u>(64,583)</u>	<u>(31,637)</u>	<u>(20,710)</u>
<b>Cash Flows from Financing Activities</b>			
Long-term borrowings .....	55,000	45,000	34,000
Payments on debt.....	(50,000)	(56,300)	(66,531)
Issuance of common stock.....	12,287	12,885	14,113
Issuance of treasury stock .....	165	125	110
Purchase of treasury stock .....	(85,738)	(76,393)	(98,912)
Dividends paid .....	(13,792)	(10,619)	(9,149)
Net cash used in financing activities .....	<u>(82,078)</u>	<u>(85,302)</u>	<u>(126,369)</u>
Net increase (decrease) in cash and cash equivalents.....	6,656	7,125	(5,442)
Cash and cash equivalents at beginning of year .....	32,151	25,026	30,468
Cash and cash equivalents at end of year .....	<u>\$ 38,807</u>	<u>\$ 32,151</u>	<u>\$ 25,026</u>

See Notes to Consolidated Financial Statements.

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

<i>In thousands</i>	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at January 1, 2002 .....	\$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 .....						<u>66,449</u>
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 .....						<u>94,161</u>
<b>Balance at December 31, 2003.....</b>	<b>\$113,281</b>	<b>\$235,996</b>	<b>\$798,974</b>	<b>\$(573,863)</b>	<b>\$(18,790)</b>	<b>\$555,598</b>
Common stock issued—employee benefit plans	175	3,347	—	—	—	3,522
Exercise of stock options for cash and by surrender of shares .....	1,049	10,345	—	(4,334)	—	7,060
Tax benefit of options exercised .....	—	3,818	—	—	—	3,818
Dividends paid (\$0.16 per share) .....	—	—	(13,792)	—	—	(13,792)
Treasury stock issued .....	—	9	—	156	—	165
Treasury stock repurchased .....	—	—	—	(85,738)	—	(85,738)
Comprehensive income, net of tax:						
Net income .....	—	—	97,568	—	—	97,568
Adjustment for minimum pension liability (net of tax of \$1,519).....	—	—	—	—	2,322	2,322
Foreign currency translation adjustment .....	—	—	—	—	1,276	1,276
Total comprehensive income .....						<u>101,166</u>
<b>Balance at December 31, 2004.....</b>	<b>\$114,505</b>	<b>\$253,515</b>	<b>\$882,750</b>	<b>\$(663,779)</b>	<b>\$(15,192)</b>	<b>\$571,799</b>

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 \$3.0 million, \$1.6 million and \$1.2 million for the years ended December 31, 2004, 2003 and 2002, 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, 2004.

At December 31, 2004 and 2003, the Company’s goodwill balance was \$458.2 million, net of \$82.0 million of accumulated amortization, and \$437.2 million, net of \$82.0 million of accumulated amortization, respectively.

The changes in the carrying amount of goodwill for the year ended December 31, 2004, are as follows:

<i>In thousands, except per share amounts</i>	Direct Marketing	Shoppers	Total
Balance at December 31, 2003.....	\$312,810	\$124,346	\$437,156
Additional purchase consideration.....	19,430	1,585	21,015
Balance at December 31, 2004.....	\$332,240	\$125,931	\$458,171

As of December 31, 2004 and 2003, 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, 2004 and 2003, all of the Company’s other intangibles with definite useful lives are related to the Company’s Direct Marketing segment. At December 31, 2004 and 2003, the balance of other intangibles was \$2.1 million, net of \$2.9 million of accumulated amortization, and \$2.7 million, net of \$2.3 million of accumulated amortization. Amortization expense related to other intangibles with definite useful lives was \$0.6 million for each of the years in the three year period ended December 31, 2004. Expected amortization expense is \$0.6 million for the year ending December 31, 2005, \$0.4 million for the years ending December 31, 2006, 2007 and 2008, and \$0.3 million for the year ending December 31, 2009.

**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:

<i>In thousands, except per share amounts</i>	<i>Year Ended December 31,</i>		
	2004	2003	2002
Net income—as reported .....	\$ 97,568	\$ 87,362	\$ 90,745
Stock-based employee compensation expense, included in reported net income, net of related tax effects .....	61	61	61
Stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects .....	(3,798)	(3,899)	(4,411)
Net income—pro forma .....	\$ 93,831	\$ 83,524	\$ 86,395
Basic earnings per share— as reported .....	\$ 1.13	\$ 0.99	\$ 0.98
Basic earnings per share— pro forma .....	\$ 1.09	\$ 0.94	\$ 0.93
Diluted earnings per share— as reported .....	\$ 1.11	\$ 0.97	\$ 0.96
Diluted earnings per share— pro forma .....	\$ 1.07	\$ 0.93	\$ 0.91

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 2004, 2003 and 2002:

	<i>Year Ended December 31,</i>		
	2004	2003	2002
Expected dividend yield.....	0.7%	0.6%	0.5%
Expected stock price volatility.....	26.3%	27.2%	27.8%
Risk free interest rate .....	3.8%	3.6%	5.4%
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 post-contract 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 individual 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 claims. 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 December 2004, the Financial Accounting Standards Board (FAS) revised SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123 focuses primarily on accounting for transactions in which an entity obtains employee

services in exchange for share-based payment transactions. This revised Statement requires public entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost is then recognized over the period during which an employee is required to provide service in exchange for the award—the requisite service period (typically the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. The grant-date fair value of employee share options and similar instruments is to be estimated using option-pricing models adjusted for the unique characteristics of those instruments. This revised Statement supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and eliminates the alternative to use the intrinsic value method of accounting prescribed by APB No. 25. Under APB No. 25, issuing stock options to employees with an exercise price equal to the market price on the date of grant generally resulted in recognition of no compensation cost. SFAS No. 123, as revised, is effective for interim periods beginning after June 15, 2005. The Company currently follows the disclosure-only provisions of SFAS No. 123 as originally issued, and accordingly no compensation expense has been recognized in the financial statements for options granted where the exercise price is equal to the market price of the underlying stock at the date of grant. The adoption of SFAS No. 123, as revised, in the Company's third fiscal quarter of 2005 will have an impact on the Company's financial position and results of operations, but at this time the Company has not determined that impact.

In December 2004, the Financial Accounting Standards Board issued Staff Positions 109-1 (FAS 109-1) and 109-2 (FAS 109-2). FAS 109-1, "Application of FASB Statement No. 109, 'Accounting for Income Taxes,' to the Tax Deduction on Qualified Production Activities provided by the American Jobs Creation Act of 2004," gives guidance on applying FASB 109 to the tax deduction on qualified production activities provided by the Act. FAS 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004," gives guidance on the Act's repatriation provision. The Company is in the process of determining the impact the American Jobs Creation Act of 2004 and the guidance from FAS 109-1 and FAS 109-2 will have on the Company's financial position and results of operations.

In November 2004, the Financial Accounting Standards Board (FAS) issued SFAS No. 151, "Inventory Costs." This Statement amended the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). ARB 43 previously required that such items be treated as current period charges only if they were considered abnormal. SFAS No. 151 requires that those items be recognized as current-period charges regardless of whether they meet the criteria for abnormal. In addition, this Statement requires the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production

facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 for the fiscal year beginning January 1, 2005 is not expected to have a material impact on the Company's financial position or results of operations.

#### Note B — Acquisitions

In December 2004, the Company acquired Postfuture, Inc., an e-mail service provider that provides both e-mail technology and services.

In April 2004, Harte-Hanks acquired *Dollar Saver*, a local shopper publication in the Hemet area in Southern California.

In February 2004, the Company acquired Avellino Technologies Ltd., a leading provider of data profiling technology.

The total cash outlay in 2004 related to acquisitions was \$29.7 million. The total cash outlay in 2003 for acquisitions was \$0.3 million. The total cash outlay in 2002 for acquisitions was \$3.8 million.

Goodwill recognized in 2004 acquisitions totaled \$21.6 million, \$20.0 million of which was assigned to the Direct Marketing segment. The remaining \$1.6 million was assigned to the Shoppers segment.

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 — Long-Term Debt

Cash payments for interest were \$1.0 million, \$0.9 million, and \$1.3 million for the years ended December 31, 2004, 2003 and 2002, respectively.

December 31,		
In thousands	2004	2003
Revolving loan commitment, various interest rates based on EUROLIBOR (effective rate of 2.91% at December 31, 2004), due October 17, 2005 .....	\$ 10,000	\$ 5,000
Less current maturities .....	10,000	—
	\$ —	\$ 5,000

#### 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, 2004, the Company had \$115 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.

#### Note D — Income Taxes

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

Year Ended December 31,			
In thousands	2004	2003	2002
<b>Current</b>			
Federal .....	\$ 47,081	\$ 37,820	\$ 41,602
State and local .....	10,539	6,376	6,026
Foreign .....	818	300	99
Total current .....	\$ 58,438	\$ 44,496	\$ 47,727
<b>Deferred</b>			
Federal .....	\$ 7,498	\$ 10,825	\$ 7,087
State and local .....	801	2,435	1,791
Foreign .....	(1,337)	(1,213)	—
Total deferred .....	\$ 6,962	\$ 12,047	\$ 8,878
Total income tax expense .....	\$ 65,400	\$ 56,543	\$ 56,605

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

Year Ended December 31,					
In thousands	2004		2003		2002
Computed expected income tax expense .....	\$57,039	35%	\$50,367	35%	\$51,572 35%
Net effect of state income taxes .....	7,371	5%	5,717	4%	4,922 3%
Change in the beginning of the year balance of the valuation allowance ..	39	0%	10	0%	159 0%
Other, net .....	951	1%	449	0%	(48) 0%
Income tax expense for the period .....	\$65,400	40%	\$56,543	38%	\$56,605 38%

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

Year Ended December 31,			
In thousands	2004	2003	2002
Results of operations .....	\$65,400	\$56,543	\$56,605
Stockholders' equity .....	(2,299)	(3,630)	(27,886)
Total .....	\$63,101	\$52,913	\$28,719



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

*December 31,*

<i>In thousands</i>	2004	2003
<b>Deferred tax assets</b>		
Deferred compensation and retirement plan .....	\$ 10,291	\$ 10,598
Accrued expenses not deductible until paid .....	5,114	4,451
Accounts receivable, net .....	662	343
Other, net .....	211	211
State income tax .....	3,236	—
Foreign net operating loss carryforwards .....	2,201	1,214
State net operating loss carryforwards .....	682	597
Capital loss carryforward .....	492	492
Total gross deferred tax assets .....	22,889	17,906
Less valuation allowance .....	(1,174)	(1,089)
Net deferred tax assets .....	21,715	16,817
<b>Deferred tax liabilities</b>		
Property, plant and equipment .....	(16,830)	(12,819)
Goodwill .....	(39,274)	(31,299)
State income tax .....	—	(870)
Total gross deferred tax liabilities .....	(56,104)	(44,988)
Net deferred tax liabilities .....	\$ (34,389)	\$ (28,171)

Net deferred taxes are recorded both as a current deferred income tax asset and as other long-term liabilities based upon the classification of the related timing difference. There are approximately \$7.9 million and \$9.1 million of deferred tax assets related to non-current items that are netted with long-term deferred tax liabilities at December 31, 2004 and 2003, respectively.

As of December 31, 2004 and 2003, the Company had net operating loss and capital loss carryforwards that are available to reduce future taxable income and that 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 that the Company will realize the benefits of these deductible differences, net of the existing valuation allowances, at December 31, 2004.

The valuation allowance for deferred tax assets as of January 1, 2003, was \$1,277,000. The valuation allowance at December 31, 2004, relates to state net operating losses of \$682,000 and capital losses of \$492,000, which are not expected to be realized. The valuation allowance at December 31, 2003, related to state net operating losses of \$597,000 and capital losses of \$492,000 that are not expected to be realized.

Cash payments for income taxes were \$50.1 million, \$39.9 million and \$37.8 million in 2004, 2003 and 2002, respectively.

#### Note E — 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 were it not for limitations imposed by income tax regulation. The benefits under this supplemental pension plan, which is an unfunded 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:

*Year Ended December 31,*

<i>In thousands</i>	2004	2003
<b>Change in benefit obligation</b>		
Benefit obligation at beginning of year .....	\$ 109,171	\$ 102,151
Service cost .....	561	523
Interest cost .....	6,568	6,561
Actuarial loss .....	1,973	4,363
Benefits paid .....	(4,741)	(4,427)
Benefit obligation at end of year .....	113,532	109,171
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year .....	89,210	64,660
Actual return on plan assets .....	10,918	16,366
Contributions .....	51	12,611
Benefits paid .....	(4,741)	(4,427)
Fair value of plan assets at end of year .....	95,438	89,210
Funded status .....	(18,094)	(19,961)
Unrecognized actuarial loss .....	35,062	38,670
Unrecognized prior service cost .....	426	491
Net amount recognized .....	\$ 17,394	\$ 19,200

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

*Year Ended December 31,*

<i>In thousands</i>	2004	2003
Accrued benefit liability .....	\$ (16,175)	\$ (18,370)
Intangible asset .....	824	984
Accumulated other comprehensive loss .....	32,745	36,586
Net amount recognized .....	\$ 17,394	\$ 19,200

The minimum pension liability included in other comprehensive income decreased \$3.8 million during the year ended December 31, 2004, and decreased \$6.7 million during the year ended December 31, 2003.

The Company is not required to make and does not intend to make a contribution to either pension plan in 2005 other than to the extent needed to cover benefit payments related to the unfunded plan.

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

*Years Ended December 31,*

<i>In thousands</i>	2004	2003
Projected benefit obligation .....	\$ 113,532	\$ 109,171
Accumulated benefit obligation .....	111,614	107,580
Fair value of plan assets .....	\$ 95,438	\$ 89,210

The Company's non-qualified, unfunded pension plan had an accumulated benefit obligation of \$10.8 million and \$10.0 million at December 31, 2004 and 2003, respectively.

Net pension cost for both plans included the following components:

*Years Ended December 31,*

<i>In thousands</i>	2004	2003	2002
Service cost .....	\$ 561	\$ 523	\$ 581
Interest cost .....	6,568	6,561	6,662
Expected return on plan assets .....	(7,396)	(5,964)	(6,931)
Amortization of prior service cost .....	64	65	65
Recognized actuarial loss (gain) .....	2,060	2,477	1,066
Net periodic benefit cost (income) .....	\$ 1,857	\$ 3,662	\$ 1,443

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

*Years Ended December 31,*

<i>In thousands</i>	2004	2003	2002
<b>Weighted-average assumptions used to determine net periodic benefit cost</b>			
Discount rate .....	6.25%	6.85%	7.40%
Expected return on plan assets .....	8.50%	9.00%	9.00%
Rate of compensation increase .....	4.00%	4.00%	4.00%

*December 31,*

**2004      2003**

<i>In thousands</i>	2004	2003
<b>Weighted-average assumptions used to determine benefit obligations</b>		
Discount rate .....	6.00%	6.25%
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, 2004 and 2003, by asset category are as follows:

*December 31,*

<i>In thousands</i>	2004	2003
Equity securities .....	\$ 67,815	\$ 63,962
Debt securities .....	26,516	23,768
Other .....	1,107	1,480
Total plan assets .....	\$ 95,438	\$ 89,210

The expected future pension benefit payments as of December 31, 2004 are as follows:

<i>In thousands</i>	
2005 .....	\$ 4,507
2006 .....	4,580
2007 .....	4,736
2008 .....	5,338
2009 .....	5,714
2010-2014 .....	35,349
	<u>\$ 60,224</u>

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%	35%-75%	S&P 500
Large Cap Growth .....	22.5%	15%-30%	Russell 1000 Growth
Large Cap Value .....	22.5%	15%-30%	Russell 1000 Value
Mid Cap Value .....	10.0%	5%-15%	Russell Mid Cap Value
Domestic Fixed Income .....	30.0%	20%-50%	LB Aggregate
International Equities .....	15.0%	10%-25%	MSCI 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 2004, 2003 and 2002 was \$6.3 million, \$6.1 million and \$6.4 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 2,826,290 at December 31, 2004.

#### Note F — Stockholders' Equity

In January 2005, the Company announced an increase in the regular quarterly dividend from 4.0 cents per share to 5.0 cents per share, payable March 15, 2005, to holders of record on March 1, 2005.

During 2004 the Company repurchased 3.6 million shares of its common stock for \$85.7 million under its stock repurchase program. In addition, the Company received 0.2 million shares of its common stock, with an estimated market value of \$4.3 million, in exchange for proceeds related to stock option exercises. As of December 31, 2004, the Company has repurchased 39.3 million shares since the beginning of its stock repurchase program in January 1997. During this period the Company has also received 1.3 million shares in exchange for proceeds related to stock option exercises. Under this program, the Company had authorization to repurchase an additional 5.6 million shares at December 31, 2004.

On April 26, 2004, the Company purchased 744,000 shares of its common stock for \$24.00 per share (\$0.24 below the closing price per share of the Company's common stock on April 26, 2004) from two trusts and a private foundation. Mr. Larry Franklin, the Chairman of the Company's Board, and Mr. David

L. Copeland, the Chairman of the Company's Audit Committee, serve as co-trustees on each of the trusts and are board members of the private foundation. Each of Messrs. Franklin and Copeland disclaim beneficial ownership of such shares.

On April 28, 2004, the Company purchased 100,000 shares of its common stock for \$24.00 per share (the closing price per share of the Company's common stock on April 28, 2004) from Mr. Houston H. Harte. On August 11, 2004, the Company purchased 100,000 shares of its common stock for \$24.00 per share (the closing price per share of the Company's common stock on August 10, 2004) from Mr. Houston H. Harte. In addition, on September 15, 2004, the Company purchased 100,000 shares of its common stock for \$24.49 per share (the closing price per share of the Company's common stock on September 15, 2004) from Mr. Houston H. Harte. Mr. Harte is a member of the Company's Board of Directors.

#### Note G — 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 20,500,000 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, 2004, 2003 and 2002, market price options to purchase 7,099,685 shares, 7,216,659 shares and 8,659,127 shares, respectively, were outstanding with exercise prices ranging from \$4.28 to \$25.48 per share at December 31, 2004. Market price options granted prior to January 1998 became 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, 2004 was \$16.29 and \$13.44, respectively. The weighted-average remaining life for outstanding market price options was 5.94 years.

At December 31, 2004, 2003 and 2002, performance options to purchase 129,000 shares, 161,325 shares and 359,625 shares, respectively, were outstanding with exercise prices ranging from \$0.22 to \$1.33 per share at December 31, 2004. No performance options have been granted since January 1999. The performance options became exercisable in whole or in part after three years, depending upon the extent to which the Company achieved certain goals established at the time the options were granted. That portion of the performance options that did not become exercisable at an earlier date becomes exercisable after the ninth anniversary of the date of grant. Compensation expense of \$0.1 million was recognized for the performance options during each of the three years ended December 31, 2004. The weighted-average exercise price for outstanding performance options and exercisable performance options at December 31, 2004, was \$0.71 and \$0.61, respectively. The weighted-average remaining life for outstanding performance options was 2.06 years.

The following summarizes all stock option plans activity during 2004, 2003 and 2002:

	Number of Shares	Weighted Average Option Price
Options outstanding at January 1, 2002 .....	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
<b>Granted .....</b>	<b>1,269,750</b>	<b>22.46</b>
<b>Exercised .....</b>	<b>(1,051,038)</b>	<b>10.68</b>
<b>Cancelled .....</b>	<b>(368,011)</b>	<b>17.35</b>
Options outstanding at December 31, 2004 .....	7,228,685	\$ 16.01
<b>Exercisable at December 31, 2004 .....</b>	<b>3,700,964</b>	<b>\$ 13.17</b>

The following table summarizes information about stock options outstanding at December 31, 2004:

Range of Exercise Prices	Number Outstanding	Outstanding		Exercisable	
		Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0.22- 8.58	860,385	1.51	\$ 6.43	805,635	\$ 6.78
\$10.25-14.50	1,404,624	4.17	\$ 12.96	1,240,627	\$ 12.90
\$14.54-15.63	954,912	5.74	\$ 14.81	540,473	\$ 14.87
\$15.75-17.45	1,027,457	5.43	\$ 16.60	737,708	\$ 16.44
\$17.98-18.61	1,015,432	7.10	\$ 18.21	218,146	\$ 18.22
\$18.79-21.23	722,125	7.76	\$ 19.87	158,375	\$ 19.96
\$22.03-25.48	1,243,750	8.16	\$ 22.47	—	—
	<u>7,228,685</u>	5.87	\$ 16.01	<u>3,700,964</u>	\$ 13.17

The weighted-average fair value of market price options granted during 2004, 2003 and 2002 was \$7.26, \$5.96 and \$6.75, respectively. The Company did not grant any performance options during 2003, 2002 or 2001.

#### Note H — 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 I — Commitments and Contingencies

At December 31, 2004, the Company had outstanding letters of credit in the amount of \$20.3 million. These letters of credit exist to support the Company's insurance programs relating to workers' compensation, automobile and general liability, and leases.

#### Note J — 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 \$27.5 million, \$29.2 million and \$29.7 million for the years ended December 31, 2004, 2003 and 2002, 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, 2004 are as follows:

<i>In thousands</i>	
2005 .....	\$ 22,372
2006 .....	17,359
2007 .....	14,260
2008 .....	9,968
2009 .....	7,322
After 2009 .....	<u>16,721</u>
	<u>\$ 88,002</u>



Note K – Selected Quarterly Data (Unaudited)

<i>In thousands, except per share amounts</i>	2004 Quarter Ended				2003 Quarter Ended			
	December 31	September 30	June 30	March 31	December 31	September 30	June 30	March 31
Revenues .....	\$ 277,491	\$ 262,566	\$ 254,152	\$ 236,252	\$ 255,721	\$ 239,366	\$ 233,169	\$ 216,320
Operating income .....	47,333	43,506	42,898	31,558	41,674	38,514	38,466	27,833
Net income .....	27,580	25,653	25,546	18,789	24,978	22,924	23,082	16,378
Basic earnings per share .....	\$ 0.32	\$ 0.30	\$ 0.30	\$ 0.21	\$ 0.29	\$ 0.26	\$ 0.26	\$ 0.18
Diluted earnings per share .....	\$ 0.32	\$ 0.29	\$ 0.29	\$ 0.21	\$ 0.28	\$ 0.26	\$ 0.26	\$ 0.18

Note L – Earnings Per Share

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

<i>In thousands, except per share amounts</i>	Year Ended December 31,		
	2004	2003	2002
<b>Basic EPS</b>			
Net income.....	\$ 97,568	\$ 87,362	\$ 90,745
Weighted-average common shares outstanding used in earnings per share computations.....	86,169	88,541	92,648
Earnings per share.....	\$ 1.13	\$ 0.99	\$ 0.98
<b>Diluted EPS</b>			
Net income.....	\$ 97,568	\$ 87,362	\$ 90,745
Shares used in diluted earnings per share computations.....	87,806	89,982	94,872
Earnings per share.....	\$ 1.11	\$ 0.97	\$ 0.96
<b>Computation of Shares Used in Earnings Per Share Computations</b>			
Average outstanding common shares.....	86,169	88,541	92,648
Average common equivalent shares—dilutive effect of option shares.....	1,637	1,441	2,224
Shares used in diluted earnings per share computations.....	87,806	89,982	94,872

For the purpose of calculating the shares used in the diluted EPS calculations, 109,000, 56,000 and 781,000 anti-dilutive market price options have been excluded from the EPS calculations for the years ended December 31, 2004, 2003 and 2002, respectively.

Note M – Business Segments

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

Harte-Hanks operates a worldwide direct and targeted marketing company that provides direct marketing services to a wide range of local, regional, national and international consumer and business-to-business marketers. The Company

utilizes advanced technologies to enable its clients to identify, reach, influence and nurture their customers. The Company believes that developments in technology and trends toward more sophisticated marketing analysis and measurement will continue to result in increased usage of direct marketing services. 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. 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 Standard 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 segment's 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 about the operations of Harte-Hanks in different business segments is set forth below based on the nature of the products and services offered. Harte-Hanks evaluates performance based on several factors, of which the primary financial measures are segment revenues and operating income. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies (Note A).

Note M – Business Segments (continued)

<i>In thousands</i>	Year Ended December 31,		
	2004	2003	2002
<b>Revenues</b>			
Direct Marketing .....	\$ 641,214	\$ 584,804	\$ 573,826
Shoppers .....	389,247	359,772	334,951
Total revenues .....	\$ 1,030,461	\$ 944,576	\$ 908,777
<b>Operating income</b>			
Direct Marketing .....	\$ 90,856	\$ 76,641	\$ 83,872
Shoppers .....	85,857	78,007	74,564
Corporate Activities.....	(11,418)	(8,161)	(8,148)
Total operating income .....	\$ 165,295	\$ 146,487	\$ 150,288
<b>Income before income taxes</b>			
Operating income .....	\$ 165,295	\$ 146,487	\$ 150,288
Interest expense .....	(1,020)	(855)	(1,208)
Interest income .....	341	168	274
Other, net .....	(1,648)	(1,895)	(2,004)
Total income before income taxes .....	\$ 162,968	\$ 143,905	\$ 147,350
<b>Depreciation</b>			
Direct Marketing .....	\$ 22,518	\$ 23,908	\$ 27,088
Shoppers .....	5,621	5,493	5,008
Corporate Activities.....	30	32	32
Total depreciation .....	\$ 28,169	\$ 29,433	\$ 32,128
<b>Goodwill and intangible amortization</b>			
Direct Marketing .....	\$ 600	\$ 600	\$ 600
Shoppers .....	—	—	—
Total goodwill and intangible amortization .....	\$ 600	\$ 600	\$ 600
<b>Capital expenditures</b>			
Direct Marketing .....	\$ 22,587	\$ 18,526	\$ 12,782
Shoppers .....	12,556	13,365	4,548
Corporate Activities.....	3	24	28
Total capital expenditures .....	\$ 35,146	\$ 31,915	\$ 17,358
<b>Total assets</b>			
Direct Marketing .....	\$ 574,033	\$ 527,733	
Shoppers .....	203,587	188,301	
Corporate Activities.....	50,733	43,096	
Total assets .....	\$ 828,353	\$ 759,130	
<b>Goodwill</b>			
Direct Marketing .....	\$ 332,240	\$ 312,810	
Shoppers .....	125,931	124,346	
Total goodwill .....	\$ 458,171	\$ 437,156	
<b>Other intangible assets</b>			
Direct Marketing .....	\$ 2,067	\$ 2,667	
Shoppers .....	—	—	
Total assets .....	\$ 2,067	\$ 2,667	

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

Year Ended December 31,

<i>In thousands</i>	2004	2003	2002
<b>Revenues<sup>a</sup></b>			
United States .....	\$ 974,258	\$ 896,788	\$ 870,700
Other countries .....	56,203	47,788	38,077
Total revenues .....	<u>\$ 1,030,461</u>	<u>\$ 944,576</u>	<u>\$ 908,777</u>
<b>Long-lived net assets<sup>b</sup></b>			
United States .....	\$ 104,877	\$ 89,733	
Other countries .....	8,893	8,014	
Total long-lived assets .....	<u>\$ 113,770</u>	<u>\$ 97,747</u>	

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

b Long-lived assets are based on physical location.

Report of Independent Registered Public Accounting Firm on Financial Statements

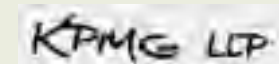
The Board of Directors and Stockholders  
Harte-Hanks, Inc.:

We have audited the accompanying consolidated balance sheets of Harte-Hanks, Inc. and subsidiaries as of December 31, 2004 and 2003, 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, 2004. 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 the standards of the Public Company Accounting Oversight Board (United States). 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Harte-Hanks, Inc. and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on criteria established in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 15, 2005, expressed an unqualified opinion thereon.



KPMG LLP  
San Antonio, Texas  
March 15, 2005

Management's Report on Internal Control Over Financial Reporting

We are responsible for the preparation and integrity of the consolidated financial statements appearing in our Annual Report. The consolidated financial statements were prepared in conformity with United States generally accepted accounting principles and include amounts based on management's estimates and judgments. All other financial information in this report has been presented on a basis consistent with the information included in the financial statements.

We are also responsible for establishing and maintaining adequate internal controls over financial reporting. We maintain a system of internal controls that is designed to provide reasonable assurance as to the fair and reliable preparation and presentation of the consolidated financial statements, as well as to safeguard assets from unauthorized use or disposition.

Our control environment is the foundation for our system of internal controls over financial reporting. It sets the tone of our organization and includes factors such as integrity and ethical values. Our internal controls over financial reporting are supported by formal policies and procedures that are reviewed, modified and improved as changes occur in business conditions and operations.

The Audit Committee of the Board of Directors, which is composed solely of outside directors, meets periodically with members of management, the internal auditors and the independent auditors to review and discuss internal controls over financial reporting and accounting and financial reporting matters. The independent auditors and internal auditors report to the Audit Committee and accordingly have full and free access to the Audit Committee at any time.

We conducted an evaluation of the effectiveness of our internal controls over financial reporting based on the framework in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. This evaluation included review of the documentation of controls, evaluation of the design effectiveness of controls, testing of the operating effectiveness of controls and a conclusion on this evaluation. Based on our evaluation, we concluded that internal control over financial reporting was effective as of December 31, 2004.

KPMG LLP, an independent registered public accounting firm, has issued an attestation report on management's assessment of internal control over financial reporting, which is included herein.

March 15, 2005

Richard Hochhauser  
President and Chief Executive Officer

Dean Blythe  
Senior Vice President and Chief Financial Officer

Jessica Huff  
Vice President, Finance and Chief Accounting Officer



## Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting

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

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Harte-Hanks, Inc. maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary

to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Harte-Hanks, Inc. and subsidiaries as of December 31, 2004 and 2003 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, 2004 and our report dated March 15, 2005 expressed an unqualified opinion thereon.



KPMG LLP  
San Antonio, Texas  
March 15, 2005

## Five-Year Financial Summary

<i>In thousands, except per share amounts</i>	2004	2003	2002	2001	2000
<b>Statement of Operations Data</b>					
Revenues .....	\$ 1,030,461	\$ 944,576	\$ 908,777	\$ 917,928	\$ 960,773
<b>Operating expenses</b>					
Payroll, production and distribution .....	755,715	692,170	652,243	653,002	693,272
Advertising, selling, general and administrative .....	80,682	75,886	73,518	76,376	85,560
Depreciation .....	28,169	29,433	32,128	32,079	28,494
Goodwill and intangible amortization .....	600	600	600	16,841	15,226
Total operating expenses .....	865,166	798,089	758,489	778,298	822,552
Operating income .....	165,295	146,487	150,288	139,630	138,221
Interest expense, net .....	679	687	934	2,578	(384)
Net income .....	97,568	87,362	90,745	79,684	81,886
Earnings per common share—diluted .....	1.11	0.97	0.96	0.82	0.78
Cash dividends per common share .....	0.16	0.12	0.10	0.08	0.07
Weighted-average common and common equivalent shares outstanding—diluted .....	87,806	89,982	94,872	97,174	104,480
<b>Adjusted data to exclude amortization of goodwill, net of tax effect<sup>a</sup></b>					
Net income .....	97,568	87,362	90,745	91,700	92,638
Earnings per common share—diluted .....	1.11	0.97	0.96	0.94	0.89
<b>Segment data</b>					
<b>Revenues</b>					
Direct Marketing .....	641,214	584,804	573,826	601,901	662,044
Shoppers .....	389,247	359,772	334,951	316,027	298,729
<b>Total revenues</b> .....	<b>\$ 1,030,461</b>	<b>\$ 944,576</b>	<b>\$ 908,777</b>	<b>\$ 917,928</b>	<b>\$ 960,773</b>
<b>Operating income</b>					
Direct Marketing .....	\$ 90,856	\$ 76,641	\$ 83,872	\$ 85,020	\$ 91,450
Shoppers .....	85,857	78,007	74,564	63,398	55,710
General corporate .....	(11,418)	(8,161)	(8,148)	(8,788)	(8,939)
<b>Total operating income</b> .....	<b>\$ 165,295</b>	<b>\$ 146,487</b>	<b>\$ 150,288</b>	<b>\$ 139,630</b>	<b>\$ 138,221</b>
<b>Operating income excluding amortization of goodwill<sup>a</sup></b>					
Direct Marketing .....	\$ 90,856	\$ 76,641	\$ 83,872	\$ 97,171	\$ 102,172
Shoppers .....	85,857	78,007	74,564	67,470	59,781
General corporate .....	(11,418)	(8,161)	(8,148)	(8,788)	(8,939)
<b>Total operating income</b> .....	<b>\$ 165,295</b>	<b>\$ 146,487</b>	<b>\$ 150,288</b>	<b>\$ 155,853</b>	<b>\$ 153,014</b>
Capital expenditures .....	\$ 35,146	\$ 31,915	\$ 17,358	\$ 26,445	\$ 36,465
<b>Balance sheet data (at end of period)</b>					
Property, plant and equipment, net .....	\$ 113,770	\$ 97,747	\$ 94,154	\$ 109,428	\$ 112,065
Goodwill and other intangibles, net .....	460,238	439,823	440,067	438,325	439,148
Total assets .....	828,353	759,130	736,732	771,049	807,105
Total long term debt .....	—	5,000	16,300	48,312	65,370
Total stockholders' equity .....	\$ 571,799	\$ 555,598	\$ 532,533	\$ 552,366	\$ 551,003

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 of the "Notes to Consolidated Financial Statements" for further discussion of SFAS No. 142.

## CORPORATE INFORMATION

### Common Stock

The Company's common stock is listed on the New York Stock Exchange (symbol: HHS). The reported high and low quarterly sales price ranges for 2004 and 2003 were as follows:

	2004		2003	
	High	Low	High	Low
First Quarter .....	23.42	21.38	19.56	17.10
Second Quarter ....	24.88	22.51	19.65	17.19
Third Quarter .....	25.68	23.56	19.98	18.35
Fourth Quarter .....	27.00	24.13	22.15	18.41

In 2004, quarterly dividends were paid at the rate of 4.0 cents per share. In 2003, quarterly dividends were paid at the rate of 3.0 cents per share.

As of January 1, 2005, there are approximately 2,600 holders of record.

The certifications over the Company's internal controls required by Section 302 of the Sarbanes-Oxley Act of 2002 have been filed as an exhibit to the Company's Form 10-K. These certifications have been submitted to the NYSE. The Company also submitted the required certification to the NYSE pursuant to NYSE Rule 303A.12(a) in 2004.

### Transfer Agent and Registrar

EquiServe Trust Company, N.A.  
PO Box 43023  
Providence, RI 02940-3023  
(781) 575-4593  
[www.equiserve.com](http://www.equiserve.com)

### Annual Meeting of Stockholders

The annual meeting of stockholders will be held at 10:00 am on May 17, 2005, 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

## DIRECTORS

**David L. Copeland**  
*President, SIPCO, Inc.*  
*Chairman, Audit Committee*

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

**Dr. Peter T. Flawn**  
*President Emeritus*  
*The University of Texas at Austin*

**Larry Franklin**  
*Chairman*

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

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

**Houston H. Harte**  
*Vice Chairman*

**Richard Hochhauser**  
*President & Chief Executive Officer*

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

## 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 LaGrega**  
*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  
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 Mary, Florida  
Langhorne, Pennsylvania  
Monroe Township, New Jersey  
New York, New York  
Ontario, California

Richardson, Texas  
River Edge, New Jersey  
San Diego, California  
Shawnee, Kansas  
Sterling Heights, Michigan  
Vineland, New Jersey  
Westville, New Jersey  
Wilkes-Barre, Pennsylvania

### NATIONAL MARKETS HEADQUARTERS

Cincinnati, Ohio

### INTERNATIONAL OFFICES

Aldermaston, United Kingdom  
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Hasselt, Belgium  
Madrid, Spain  
Melbourne, Australia  
São Paulo, Brazil  
Sèvres, France  
Stuttgart, Germany  
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## SHOPPERS

**The Flyer**  
South Florida  
<http://www.theflyer.com>

**PennySaver**  
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