

HARTE HANKS INC  
Form 10-Q  
August 09, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-7120

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**HARTE-HANKS, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**74-1677284**  
(I.R.S. Employer  
Identification Number)

**200 Concord Plaza Drive, San Antonio, Texas**  
(Address of principal executive offices)

**78216**  
(Zip Code)

Registrant's telephone number including area code **210/829-9000**

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock: \$1 par value per share, 72,770,593 shares as of July 31, 2007.

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HARTE-HANKS, INC. AND SUBSIDIARIES

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Harte-Hanks, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (in thousands, except per share and share amounts)

|  | June 30,<br>2007<br>(Unaudited) | December 31,<br>2006<br>(Audited) |
|--|---------------------------------|-----------------------------------|
| <b>Assets</b>  |                                 |                                   |
| Current assets   |                                 |                                   |
| Cash and cash equivalents  | \$ 33,955                       | \$ 38,270                         |
| Accounts receivable <i>(less allowance for doubtful accounts of \$3,488 and \$3,928 at June 30, 2007 and December 31, 2006, respectively)</i>                        | 170,749                         | 189,444                           |
| Inventory  | 7,149                           | 7,956                             |
| Prepaid expenses   | 17,017                          | 18,207                            |
| Current deferred income tax asset  | 14,830                          | 17,319                            |
| Other current assets   | 8,616                           | 8,779                             |
| <b>Total current assets</b>  | <b>252,316</b>                  | <b>279,975</b>                    |
| Property, plant and equipment <i>(less accumulated depreciation of \$229,748 and \$220,314 at June 30, 2007 and December 31, 2006, respectively)</i>                 | 113,735                         | 116,591                           |
| Goodwill, net  | 544,848                         | 545,347                           |
| Other intangible assets <i>(less accumulated amortization of \$8,707 and \$6,826 at June 30, 2007 and December 31, 2006, respectively)</i>                           | 22,566                          | 23,448                            |
| Other assets   | 11,083                          | 3,924                             |
| <b>Total assets</b>  | <b>\$ 944,548</b>               | <b>\$ 969,285</b>                 |
| <b>Liabilities and Stockholders' Equity</b>  |                                 |                                   |
| Current liabilities  |                                 |                                   |
| Accounts payable   | \$ 59,617                       | \$ 58,853                         |
| Accrued payroll and related expenses   | 19,504                          | 27,966                            |
| Customer deposits and unearned revenue   | 64,585                          | 61,275                            |
| Income taxes payable   | 9,932                           | 10,608                            |
| Other current liabilities  | 8,362                           | 12,534                            |
| <b>Total current liabilities</b>   | <b>162,000</b>                  | <b>171,236</b>                    |
| Long-term debt   | 212,000                         | 205,000                           |
| Other long-term liabilities  | 102,426                         | 99,573                            |
| <b>Total liabilities</b>   | <b>476,426</b>                  | <b>475,809</b>                    |
| Stockholders' equity   |                                 |                                   |
| Common stock, \$1 par value per share, 250,000,000 shares authorized. 117,127,825 and 116,497,473 shares issued at June 30, 2007 and December 31, 2006, respectively | 117,128                         | 116,497                           |
| Additional paid-in capital   | 311,758                         | 295,555                           |
| Retained earnings  | 1,106,282                       | 1,073,395                         |
| Less treasury stock: 44,115,551 and 41,282,969 shares at cost at June 30, 2007 and December 31, 2006, respectively   | (1,050,873)                     | (974,625)                         |
| Accumulated other comprehensive loss   | (16,173)                        | (17,346)                          |

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|  |            |            |
|--|------------|------------|
| Total stockholders' equity                 | 468,122    | 493,476    |
| Total liabilities and stockholders' equity | \$ 944,548 | \$ 969,285 |

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Operations (in thousands, except per share amounts)

(Unaudited)

|  | <b>Three Months Ended June 30,</b> |             |
|--|------------------------------------|-------------|
|  | <b>2007</b>                        | <b>2006</b> |
| Operating revenues   | \$ 290,145                         | \$ 298,372  |
| Operating expenses   |                                    |             |
| Labor  | 113,636                            | 110,482     |
| Production and distribution                                      | 100,526                            | 106,138     |
| Advertising, selling, general and administrative                 | 25,260                             | 21,761      |
| Depreciation and amortization                                    | 8,293                              | 7,870       |
| Intangible amortization  | 851                                | 573         |
| Total operating expenses   | 248,566                            | 246,824     |
| Operating income   | 41,579                             | 51,548      |
| Other expenses (income)  |                                    |             |
| Interest expense   | 3,263                              | 1,013       |
| Interest income  | (128)                              | (85)        |
| Other, net   | 234                                | 465         |
|  | 3,369                              | 1,393       |
| Income before income taxes                                       | 38,210                             | 50,155      |
| Income tax expense   | 15,315                             | 19,966      |
| Net income   | \$ 22,895                          | \$ 30,189   |
| Basic earnings per common share                                  | \$ 0.31                            | \$ 0.38     |
| Weighted-average common shares outstanding                       | 73,398                             | 80,329      |
| Diluted earnings per common share                                | \$ 0.31                            | \$ 0.37     |
| Weighted-average common and common equivalent shares outstanding | 74,796                             | 81,915      |

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Operations (in thousands, except per share amounts)

(Unaudited)

|  | <b>Six Months Ended June 30,</b> |             |
|--|----------------------------------|-------------|
|  | <b>2007</b>                      | <b>2006</b> |
| Operating revenues   | \$ 573,173                       | \$ 576,767  |
| Operating expenses   |                                  |             |
| Labor  | 230,792                          | 218,401     |
| Production and distribution                                      | 200,542                          | 207,989     |
| Advertising, selling, general and administrative                 | 45,650                           | 42,999      |
| Depreciation and amortization                                    | 16,614                           | 15,325      |
| Intangible amortization  | 1,881                            | 935         |
| Total operating expenses   | 495,479                          | 485,649     |
| Operating income   | 77,694                           | 91,118      |
| Other expenses (income)  |                                  |             |
| Interest expense   | 6,257                            | 1,868       |
| Interest income  | (304)                            | (111)       |
| Other, net   | 354                              | 729         |
|  | 6,307                            | 2,486       |
| Income before income taxes                                       | 71,387                           | 88,632      |
| Income tax expense   | 28,165                           | 34,660      |
| Net income   | \$ 43,222                        | \$ 53,972   |
| Basic earnings per common share                                  | \$ 0.58                          | \$ 0.67     |
| Weighted-average common shares outstanding                       | 74,057                           | 80,826      |
| Diluted earnings per common share                                | \$ 0.57                          | \$ 0.65     |
| Weighted-average common and common equivalent shares outstanding | 75,530                           | 82,472      |

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Cash Flows (in thousands)

(Unaudited)

|   | <b>Six Months Ended June 30,</b> |                  |
|---|----------------------------------|------------------|
|   | <b>2007</b>                      | <b>2006</b>      |
| <b>Cash Flows from Operating Activities</b>                                       |                                  |                  |
| Net income  | \$ 43,222                        | \$ 53,972        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                  |                  |
| Depreciation and amortization   | 16,614                           | 15,325           |
| Intangible amortization   | 1,881                            | 935              |
| Stock-based compensation  | 3,522                            | 3,659            |
| Excess tax benefits from stock-based compensation                                 | (1,758)                          | (2,066)          |
| Deferred income taxes   | 3,336                            | 2,457            |
| Other, net  | 227                              | 915              |
| Changes in operating assets and liabilities, net of acquisitions:                 |                                  |                  |
| Decrease in accounts receivable, net  | 18,695                           | 13,509           |
| Decrease (increase) in inventory  | 807                              | (1,500)          |
| Decrease (increase) in prepaid expenses and other current assets                  | 1,353                            | (5,492)          |
| Increase in accounts payable  | 783                              | 694              |
| Decrease in other accrued expenses and other current liabilities                  | (7,623)                          | (1,619)          |
| Other, net  | (4,518)                          | (3,444)          |
| <b>Net cash provided by operating activities</b>                                  | <b>76,541</b>                    | <b>77,345</b>    |
| <b>Cash Flows from Investing Activities</b>                                       |                                  |                  |
| Acquisitions, net of cash acquired  |                                  | (3,093)          |
| Purchases of property, plant and equipment  | (13,933)                         | (17,390)         |
| Proceeds from sale of property, plant and equipment                               | 111                              | 48               |
| <b>Net cash used in investing activities</b>                                      | <b>(13,822)</b>                  | <b>(20,435)</b>  |
| <b>Cash Flows from Financing Activities</b>                                       |                                  |                  |
| Long-term borrowings  | 39,000                           | 69,000           |
| Repayment of long-term borrowings   | (32,000)                         | (61,000)         |
| Issuance of common stock  | 10,558                           | 7,781            |
| Purchase of treasury stock  | (76,241)                         | (63,119)         |
| Issuance of treasury stock  | 71                               | 103              |
| Excess tax benefits from stock-based compensation                                 | 1,758                            | 2,066            |
| Dividends paid  | (10,335)                         | (9,560)          |
| <b>Net cash used in financing activities</b>                                      | <b>(67,189)</b>                  | <b>(54,729)</b>  |
| Effect of exchange rate changes on cash and cash equivalents                      | 155                              | 186              |
| Net (decrease) increase in cash and cash equivalents                              | (4,315)                          | 2,367            |
| Cash and cash equivalents at beginning of year                                    | 38,270                           | 24,561           |
| <b>Cash and cash equivalents at end of period</b>                                 | <b>\$ 33,955</b>                 | <b>\$ 26,928</b> |



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See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity and Comprehensive Income (in thousands, except per share amounts)

(2007 Unaudited)

|   | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders<br>Equity |
|---|-----------------|----------------------------------|----------------------|-------------------|--|---------------------------------|
| Balance at December 31, 2005  | \$ 115,453      | \$ 269,865                       | \$ 980,505           | \$ (782,495)      | \$ (21,982)  | \$ 561,346                      |
| Common stock issued- employee benefit plans                               | 201             | 4,277                            |                      |                   |  | 4,478                           |
| Exercise of stock options for cash and by surrender of shares             | 843             | 9,679                            |                      | (6,293)           |  | 4,229                           |
| Tax benefit of options exercised  |                 | 3,769                            |                      |                   |  | 3,769                           |
| Stock-based compensation  |                 | 7,941                            |                      |                   |  | 7,941                           |
| Dividends paid (\$0.24 per share)   |                 |                                  | (18,902)             |                   |  | (18,902)                        |
| Treasury stock repurchased  |                 |                                  |                      | (186,003)         |  | (186,003)                       |
| Treasury stock issued   |                 | 24                               |                      | 166               |  | 190                             |
| Comprehensive income, net of tax:   |                 |                                  |                      |                   |  |                                 |
| Net income  |                 |                                  | 111,792              |                   |  | 111,792                         |
| Adjustment for minimum pension liability (net of tax expense of \$16,297) |                 |                                  |                      |                   | 24,909   | 24,909                          |
| Foreign currency translation adjustment                                   |                 |                                  |                      |                   | 1,290  | 1,290                           |
| <b>Total comprehensive income</b>   |                 |                                  |                      |                   |  | <b>137,991</b>                  |
| Adjustment to initially adopt SFAS 158 (net of tax benefit of \$14,108)   |                 |                                  |                      |                   | (21,563)   | (21,563)                        |
| Balance at December 31, 2006  | \$ 116,497      | \$ 295,555                       | \$ 1,073,395         | \$ (974,625)      | \$ (17,346)  | \$ 493,476                      |
| Common stock issued- employee benefit plans                               | 94              | 2,045                            |                      |                   |  | 2,139                           |
| Exercise of stock options for cash and by surrender of shares             | 537             | 7,953                            |                      | (69)              |  | 8,421                           |
| Tax benefit of options exercised  |                 | 2,674                            |                      |                   |  | 2,674                           |
| Stock-based compensation  |                 | 3,522                            |                      |                   |  | 3,522                           |
| Dividends paid (\$0.14 per share)   |                 |                                  | (10,335)             |                   |  | (10,335)                        |
| Treasury stock repurchased  |                 |                                  |                      | (76,241)          |  | (76,241)                        |
| Treasury stock issued   |                 | 9                                |                      | 62                |  | 71                              |
| Comprehensive income, net of tax:   |                 |                                  |                      |                   |  |                                 |
| Net income  |                 |                                  | 43,222               |                   |  | 43,222                          |
| Adjustment to pension liability (net of tax expense of \$513)             |                 |                                  |                      |                   | 786  | 786                             |
| Foreign currency translation adjustment                                   |                 |                                  |                      |                   | 387  | 387                             |
| <b>Total comprehensive income</b>   |                 |                                  |                      |                   |  | <b>44,395</b>                   |
| Balance at June 30, 2007  | \$ 117,128      | \$ 311,758                       | \$ 1,106,282         | \$ (1,050,873)    | \$ (16,173)  | \$ 468,122                      |

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

**Note A - Basis of Presentation**

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of Harte-Hanks, Inc. and its subsidiaries (the Company ). Intercompany transactions and balances have been eliminated.

The statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2006.

As used in this report, the terms Harte-Hanks, we, us, or our may refer to Harte-Hanks, one or more of its consolidated subsidiaries, or all of them taken as a whole.

**Note B - Income Taxes**

Our second quarter 2007 income tax provision of \$15.3 million was calculated using an effective income tax rate of approximately 40.1%. Our first half 2007 income tax provision of \$28.2 million was calculated using an effective income tax rate of approximately 39.5%. Our effective income tax rate is derived by estimating pretax income and income tax expense for the year ending December 31, 2007. The effective income tax rate calculated is higher than the federal statutory rate of 35% due to the addition of state taxes and to certain expenses recorded for financial reporting purposes that are not deductible for federal income tax purposes.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), on January 1, 2007. We did not recognize a change to our unrecognized tax benefits as a result of this adoption. At January 1, 2007, unrecognized tax benefits totaled \$11.7 million, of which \$1.1 million represents accruals for interest and penalties that were recorded as additional tax expense in accordance with our accounting policy. If recognized, \$7.8 million, net of tax, would impact the effective tax rate. There have been no significant changes to these amounts during the quarter or six months ended June 30, 2007.

Harte-Hanks, Inc. and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state, local and foreign jurisdictions. With the exception of a few state returns, we are no longer subject to U.S. federal, state, local or non-U.S. income tax examinations by tax authorities for the years prior to 2003. The statute of limitations on the other 2002 tax returns will expire during 2007. An audit of the 2003 U.S. federal return has been completed. We believe that it is reasonably possible that a reduction in our unrecognized tax liabilities in the range of \$1.6 million to \$1.8 million, net of tax, will occur in the next twelve months related to the statute expiring on various tax returns. If this reduction were to occur, it would decrease the tax expense and effective tax rate for the full year 2007.

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We recognized \$1.9 million of stock-based compensation during the three months ended June 30, 2007 and 2006. We recognized \$3.5 million and \$3.7 million of stock-based compensation during the six months ended June 30, 2007 and 2006, respectively. Our annual grant of stock-based awards occurred in the first quarter, which is consistent with the timing of previous annual grants. We did not have any significant stock-based compensation activity in the second quarter of 2007.

**Note D - Earnings Per Share**

Basic earnings per share is computed on the basis of the weighted number of shares of the common stock outstanding during the period. Diluted earnings per share is computed on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and nonvested shares.

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

| <b>In thousands, except per share amounts</b>   | <b>Three Months Ended June 30,</b> |             |
|---|------------------------------------|-------------|
|   | <b>2007</b>                        | <b>2006</b> |
| <b>BASIC EPS</b>  |                                    |             |
| Net Income  | \$ 22,895                          | \$ 30,189   |
| Weighted-average common shares outstanding used in earnings per share computations    | 73,398                             | 80,329      |
| Earnings per common share   | \$ 0.31                            | \$ 0.38     |
| <b>DILUTED EPS</b>  |                                    |             |
| Net Income  | \$ 22,895                          | \$ 30,189   |
| Shares used in diluted earnings per share computations                                | 74,796                             | 81,915      |
| Earnings per common share   | \$ 0.31                            | \$ 0.37     |
| <b>Computation of shares used in earnings per share computations:</b>                 |                                    |             |
| Weighted-average outstanding common shares  | 73,398                             | 80,329      |
| Weighted-average common equivalent shares dilutive effect of stock options and awards | 1,398                              | 1,586       |
| Shares used in diluted earnings per share computations                                | 74,796                             | 81,915      |

2.4 million and 2.0 million anti-dilutive market price options have been excluded from the calculation of shares used in the diluted EPS calculation for the three months ended June 30, 2007 and 2006, respectively.

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| In thousands, except per share amounts  | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2007                      | 2006      |
| <b>BASIC EPS</b>  |                           |           |
| Net Income  | \$ 43,222                 | \$ 53,972 |
| Weighted-average common shares outstanding used in earnings per share computations    | 74,057                    | 80,826    |
| Earnings per common share   | \$ 0.58                   | \$ 0.67   |
| <b>DILUTED EPS</b>  |                           |           |
| Net Income  | \$ 43,222                 | \$ 53,972 |
| Shares used in diluted earnings per share computations                                | 75,530                    | 82,472    |
| Earnings per common share   | \$ 0.57                   | \$ 0.65   |
| <b>Computation of shares used in earnings per share computations:</b>                 |                           |           |
| Weighted-average outstanding common shares  | 74,057                    | 80,826    |
| Weighted-average common equivalent shares dilutive effect of stock options and awards | 1,473                     | 1,646     |
| Shares used in diluted earnings per share computations                                | 75,530                    | 82,472    |

2.3 million and 1.9 million anti-dilutive market price options have been excluded from the calculation of shares used in the diluted EPS calculation for the six months ended June 30, 2007 and 2006, respectively.

**Note E Business Segments**

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

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Information about the operations of Harte-Hanks in our two different business segments follows:

| <b>In thousands</b>              | <b>Three Months Ended June 30,</b> |             |
|----------------------------------|------------------------------------|-------------|
|                                  | <b>2007</b>                        | <b>2006</b> |
| Operating revenues               |                                    |             |
| Direct Marketing                 | \$ 174,472                         | \$ 173,808  |
| Shoppers                         | 115,673                            | 124,564     |
| Total operating revenues         | \$ 290,145                         | \$ 298,372  |
| Operating Income                 |                                    |             |
| Direct Marketing                 | \$ 24,334                          | \$ 28,577   |
| Shoppers                         | 20,344                             | 26,274      |
| Corporate Activities             | (3,099)                            | (3,303)     |
| Total operating income           | \$ 41,579                          | \$ 51,548   |
| Income before income taxes       |                                    |             |
| Operating income                 | \$ 41,579                          | \$ 51,548   |
| Interest expense                 | (3,263)                            | (1,013)     |
| Interest income                  | 128                                | 85          |
| Other, net                       | (234)                              | (465)       |
| Total income before income taxes | \$ 38,210                          | \$ 50,155   |
|                                  |                                    |             |
| <b>In thousands</b>              | <b>Six Months Ended June 30,</b>   |             |
|                                  | <b>2007</b>                        | <b>2006</b> |
| Operating revenues               |                                    |             |
| Direct Marketing                 | \$ 345,645                         | \$ 338,126  |
| Shoppers                         | 227,528                            | 238,641     |
| Total operating revenues         | \$ 573,173                         | \$ 576,767  |
| Operating Income                 |                                    |             |
| Direct Marketing                 | \$ 44,762                          | \$ 48,961   |
| Shoppers                         | 39,089                             | 48,200      |
| Corporate Activities             | (6,157)                            | (6,043)     |
| Total operating income           | \$ 77,694                          | \$ 91,118   |
| Income before income taxes       |                                    |             |
| Operating income                 | \$ 77,694                          | \$ 91,118   |
| Interest expense                 | (6,257)                            | (1,868)     |
| Interest income                  | 304                                | 111         |
| Other, net                       | (354)                              | (729)       |
| Total income before income taxes | \$ 71,387                          | \$ 88,632   |

**Note F Components of Net Periodic Pension Benefit Cost**

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

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In 1994, we 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 our principal pension plan if it were not for limitations imposed by income tax regulation. The benefits under this supplemental pension plan will continue to accrue as if the principal pension plan had not been frozen.

Net pension cost for both plans included the following components:

| <b>In thousands</b>                                | <b>Three Months Ended June 30,</b> |               |
|--|------------------------------------|---------------|
|  | <b>2007</b>                        | <b>2006</b>   |
| Service Cost                                       | \$ 191                             | \$ 198        |
| Interest Cost                                      | 1,945                              | 1,815         |
| Expected return on plan assets                     | (2,262)                            | (2,002)       |
| Amortization of prior service cost                 | 15                                 | 15            |
| Amortization of unrecognized transition obligation | 24                                 | 24            |
| Recognized actuarial loss                          | 611                                | 710           |
| <b>Net periodic benefit cost</b>                   | <b>\$ 524</b>                      | <b>\$ 760</b> |

| <b>In thousands</b>                                | <b>Six Months Ended June 30,</b> |                 |
|--|----------------------------------|-----------------|
|  | <b>2007</b>                      | <b>2006</b>     |
| Service Cost                                       | \$ 383                           | \$ 397          |
| Interest Cost                                      | 3,889                            | 3,630           |
| Expected return on plan assets                     | (4,440)                          | (4,004)         |
| Amortization of prior service cost                 | 30                               | 30              |
| Amortization of unrecognized transition obligation | 48                               | 48              |
| Recognized actuarial loss                          | 1,221                            | 1,419           |
| <b>Net periodic benefit cost</b>                   | <b>\$ 1,131</b>                  | <b>\$ 1,520</b> |

We made a \$5.0 million contribution to our frozen pension plan in May 2007 in order to obtain the Pension Benefit Guaranty Corporation full funding limit exemption. We are not required to make and do not intend to make any additional contributions to either pension plan for the remainder of 2007 other than to the extent needed to cover benefit payments related to the unfunded plan. As a result of the \$5.0 million contribution, our expected return on plan assets for 2007 increased \$0.3 million. This is expected to decrease our net periodic benefit cost in the second half of the year by approximately \$0.2 million.



**Table of Contents****Note G Comprehensive Income**

Comprehensive income for a period encompasses net income and all other changes in equity other than from transactions with our stockholders. Our comprehensive income was as follows:

| <b>In thousands</b>                                   | <b>Three Months Ended June 30,</b> |                  |
|---|------------------------------------|------------------|
|   | <b>2007</b>                        | <b>2006</b>      |
| Net income  | \$ 22,895                          | \$ 30,189        |
| Other comprehensive income:                           |                                    |                  |
| Adjustment to pension liability (net of tax of \$513) | 786                                |                  |
| Foreign currency translation adjustment               | 259                                | 729              |
| <b>Total comprehensive income</b>                     | <b>\$ 23,940</b>                   | <b>\$ 30,918</b> |

| <b>In thousands</b>                                   | <b>Six Months Ended June 30,</b> |                  |
|---|----------------------------------|------------------|
|   | <b>2007</b>                      | <b>2006</b>      |
| Net income  | \$ 43,222                        | \$ 53,972        |
| Other comprehensive income:                           |                                  |                  |
| Adjustment to pension liability (net of tax of \$513) | 786                              |                  |
| Foreign currency translation adjustment               | 387                              | 1,038            |
| <b>Total comprehensive income</b>                     | <b>\$ 44,395</b>                 | <b>\$ 55,010</b> |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Cautionary Note Regarding Forward-Looking Statements**

This report and, in particular, this Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) contain forward-looking statements within the meaning of the federal securities laws. All such statements are qualified by this cautionary note, which is provided pursuant to the safe harbor provisions of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may also be included in our other public filings, press releases, our website and oral and written presentations by management. Statements other than historical facts are forward-looking and may be identified by words such as may, will, expects, believes, anticipates, plans, estimates, seeks, could, intends, or words of similar meaning. Examples include statements regarding (1) our strategies and initiatives, (2) our financial outlook, including adjustments to our cost structure and other actions designed to improve our financial performance, (3) our expectations for our businesses and for the industries in which we operate, (4) competitive factors, (5) acquisition and development plans, (6) our stock repurchase program, (7) expectations regarding pending legal proceedings, and (8) other statements regarding future events, conditions or outcomes. These forward-looking statements are based on current information, expectations and estimates and involve risks, uncertainties, assumptions and other factors that are difficult to predict and that could cause actual results to vary materially from what is expressed in or indicated by the forward-looking statements. In that event, our business, financial condition, results of operations or liquidity could be materially adversely affected and investors in our securities could lose part or all of their investments. Some of these risks, uncertainties, assumptions and other factors can be found in our filings with the Securities and Exchange Commission, including the factors discussed under Item 1A. Risk Factors in our Annual Report on Form 10-K for the year

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ended December 31, 2006 (2006 Form 10-K) and any updates thereto in our Forms 10-Q. The forward-looking statements included in this report and those included in our other public filings, press releases, our website and oral and written presentations by management are made only as of the respective dates thereof, and we undertake no obligation to update publicly any forward-looking statement in this report or in other documents, our website or oral statements for any reason, even if new information becomes available or other events occur in the future.

**Overview**

The following MD&A section is intended to help the reader understand the results of operations and financial condition of Harte-Hanks, Inc. (Harte-Hanks). This section is provided as a supplement to, and should be read in conjunction with, our financial statements and the accompanying notes to the financial statements contained elsewhere in this report and our MD&A section, financial statements and accompanying notes to financial statements in our 2006 Form 10-K. Our 2006 Form 10-K contains a discussion of other matters not included herein, such as disclosures regarding critical accounting policies and estimates, and contractual obligations.

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. We manage our operations through two operating segments: Direct Marketing and Shoppers.

Harte-Hanks Direct Marketing improves the return on its clients' marketing investment by increasing their prospect and customer value through a process of customer optimization organized around five strategic considerations:

Information (data collection/management);

Opportunity (data access/utilization);

Insight (data analysis/interpretation);

Engagement (knowledge application); and

Interaction (program execution).

We utilize various capabilities and technologies to enable our clients to identify, reach, influence and nurture their customers. The services and products offered by Direct Marketing are tailored to specific industries or markets. Our direct marketing business services various vertical markets including retail, high-tech/telecom, financial services, pharmaceutical/healthcare, and a wide range of selected markets. Depending on the needs of our clients, our direct marketing capabilities are provided in an integrated approach through more than 30 facilities worldwide, more than 10 of which are located outside of the United States. Each of these centers possesses some specialization and is linked with others to support the needs of our clients. Revenues from the Direct Marketing segment represented approximately 60% of our total revenue for the three months ended June 30, 2007.

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. 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. As of June 30, 2007, our shoppers are zoned into more than 1,000 separate editions with circulation of approximately 13 million each week in California and Florida. Our Shoppers segment also provides advertising services online through our websites, *ThePennySaverUSA.com* and *TheFlyer.com*. Revenues from the Shoppers segment represented approximately 40% of our total revenue for the

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three months ended June 30, 2007.

We derive revenues from the sale of direct marketing services and shopper advertising services. As a worldwide business, direct marketing is affected by, among other things, general national and international economic trends. Our shoppers operate in local markets and are largely affected by the strength of the local economies in California and Florida.

Our overall strategy is based on seven key elements:

Being a market leader in each of our businesses;

Increasing revenues through growing our base businesses;

Introducing new services and products;

Entering new markets and making acquisitions;

Using technology to create competitive advantages;

Employing people who understand our clients' business and markets; and

Creating shareholder value.

Our principal expense items are labor, postage and transportation.

**Results of Operations**

Operating results were as follows:

| In thousands, except<br>per share amounts | Three months ended |               |        | Six months ended |               |        |
|---|--------------------|---------------|--------|------------------|---------------|--------|
|   | June 30, 2007      | June 30, 2006 | Change | June 30, 2007    | June 30, 2006 | Change |
| Revenues                                  | \$ 290,145         | \$ 298,372    | -2.8%  | \$ 573,173       | \$ 576,767    | -0.6%  |
| Operating expenses                        | 248,566            | 246,824       | 0.7%   | 495,479          | 485,649       | 2.0%   |
| Operating income                          | \$ 41,579          | \$ 51,548     | -19.3% | \$ 77,694        | \$ 91,118     | -14.7% |
| Net income                                | \$ 22,895          | \$ 30,189     | -24.2% | \$ 43,222        | \$ 53,972     | -19.9% |
| Diluted earnings per share                | \$ 0.31            | \$ 0.37       | -16.2% | \$ 0.57          | \$ 0.65       | -12.3% |

2<sup>nd</sup> Quarter 2007 vs. 2<sup>nd</sup> Quarter 2006

*Revenues*

Consolidated revenues decreased 2.8%, to \$290.1 million, and operating income decreased 19.3% to \$41.6 million in the second quarter of 2007 when compared to the second quarter of 2006. Our overall results reflect decreased revenues of 7.1% from our Shoppers segment, partially offset by increased revenues of 0.4% from our Direct Marketing segment. The revenue performance from Shoppers was the result of decreased sales in established markets, primarily attributable to the challenging real estate and associated financing markets in the California and Florida geographies in which we operate, and the discontinuation of commercial printing operations in our Tampa facility. Direct Marketing comparisons were affected by \$7.0 million of revenue recognized in the second quarter of 2006 relating to a contract termination fee received from one of our customers in the financial vertical. Excluding revenues from this contract termination, Direct Marketing's second quarter 2007 revenues would have been up \$7.7 million, or 4.6%, and consolidated revenues would have been down less than 1% compared to the second quarter of 2006.

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### *Operating Expenses*

Overall operating expenses increased 0.7%, to \$248.6 million, in the second quarter of 2007 compared to the second quarter of 2006. This increase includes approximately \$1 million of costs recognized in our Shoppers segment related to the shut down of approximately 600,000 of unprofitable circulation at the end of June 2007, and approximately \$1 million of costs recognized in our Direct Marketing segment as part of an initiative to reduce fixed costs and headcount. For the quarter, Direct Marketing operating expenses increased 3.4% while Shoppers operating expenses decreased 3.0% and general corporate expense decreased 6.2%. Direct Marketing's results were impacted by \$2.4 million of operating expense recognized in the second quarter of 2006 as a result of the contract termination discussed above.

### *Net Income/Earnings Per Share*

Net income decreased 24.2%, to \$22.9 million, and diluted earnings per share decreased 16.2%, to \$0.31 per share, in the second quarter of 2007 when compared to the second quarter of 2006. The decrease in net income was a result of decreased operating income, increased interest expense and a higher effective tax rate in the second quarter of 2007 when compared to the second quarter of 2006.

As discussed above, in the second quarter of 2007 we began an initiative to reduce fixed costs and headcount in both of our businesses. We plan to take additional steps in the second half of the year in both businesses to further align our cost structure with the current revenue environment and we will recognize additional costs in the second half of 2007 as we continue this initiative. For the full year 2007, we anticipate that these costs will exceed the overall benefit we will experience as a result of this initiative.

### First Half 2007 vs. First Half 2006

#### *Revenues*

Consolidated revenues decreased 0.6%, to \$573.2 million, and operating income decreased 14.7% to \$77.7 million in the first half of 2007 when compared to the first half of 2006. The revenue performance from Shoppers was the result of decreased sales in established markets, primarily attributable to the challenging real estate and associated financing markets in the California and Florida geographies in which we operate, and the discontinuation of commercial printing operations in our Tampa facility. Direct Marketing comparisons were affected by \$7.0 million of revenue recognized in the second quarter of 2006 relating to a contract termination fee described above. Excluding revenues from this contract termination, Direct Marketing's first half 2007 revenues would have been up \$14.5 million, or 4.4%, and consolidated revenues would have been up 0.6% compared to the first half of 2006.

#### *Operating Expenses*

Overall operating expenses increased 2.0%, to \$495.5 million, in the first half of 2007 compared to the first half of 2006. This increase includes approximately \$1 million of costs recognized in our Shoppers segment related to the shut down of approximately 600,000 of unprofitable circulation at the end of June 2007, and approximately \$1 million of costs recognized in our Direct Marketing segment as part of an initiative to reduce fixed costs and headcount. Direct Marketing operating expenses increased 4.1% and general corporate expense increased 1.9%, while Shoppers operating expenses decreased 1.1%. Direct Marketing's results were impacted by \$2.4 million of operating expense recognized in the second quarter of 2006 as a result of the contract termination discussed above.

#### *Net Income/Earnings Per Share*

Net income decreased 19.9%, to \$43.2 million, and diluted earnings per share decreased 12.3%, to \$0.57 per share, in the first half of 2007 when compared to the first half of 2006. The decrease in net income was a result of decreased operating income, increased interest expense and a higher effective tax rate in the first half of 2007 when compared to the first half of 2006.

**Table of Contents****Direct Marketing**

Direct Marketing operating results were as follows:

| In thousands       | Three months ended |               |        | Six months ended |               |        |
|--------------------|--------------------|---------------|--------|------------------|---------------|--------|
|                    | June 30, 2007      | June 30, 2006 | Change | June 30, 2007    | June 30, 2006 | Change |
| Revenues           | \$ 174,472         | \$ 173,808    | 0.4%   | \$ 345,645       | \$ 338,126    | 2.2%   |
| Operating expenses | 150,138            | 145,231       | 3.4%   | 300,883          | 289,165       | 4.1%   |
| Operating income   | \$ 24,334          | \$ 28,577     | -14.8% | \$ 44,762        | \$ 48,961     | -8.6%  |

**2<sup>nd</sup> Quarter 2007 vs. 2<sup>nd</sup> Quarter 2006***Revenues*

Direct Marketing revenues increased \$0.7 million, or 0.4%, in the second quarter of 2007 compared to the second quarter of 2006. These year-over-year comparisons were affected by \$7.0 million of revenue recognized in the second quarter of 2006 relating to a contract termination fee received from one of our customers in the financial vertical. Excluding revenues from this contract termination, second quarter 2007 revenues would have been up \$7.7 million, or 4.6%, compared to the second quarter of 2006. Our high tech/telecom vertical, which was helped by our September 2006 acquisition of Aberdeen Group, Inc. (Aberdeen), was up double digits and our select vertical grew in the high single digits. Our pharma/healthcare vertical was up in the mid-single digits, while our retail vertical was flat in the quarter. Excluding the 2006 impact of the contract termination fee, our financial vertical was down in the high single digits. Revenues from our vertical markets are impacted by, among other things, the economic fundamentals of each industry, various market factors, including the demand for services by our clients, and the financial condition of and budgets available to specific clients. Revenues for Direct Marketing are affected by a number of factors, including general national and international economic trends.

From a service offering perspective, Direct Marketing experienced increased revenues from telesales, market research and analytics, and internet services. Partially offsetting these increases were declines in revenues from print and data and database processing.

The acquisitions of StepDot Software GmbH in June 2006, Global Address in July 2006 and Aberdeen in September 2006 also positively affected our revenues in the second quarter of 2007 compared to the second quarter of 2006. The sale of a print operation in October 2006 negatively affected our revenues in the second quarter of 2007 compared to the second quarter of 2006.

Future revenues will depend on, among other factors, how successful we are at growing business with existing clients, acquiring new clients, meeting client demands, and the strength of the national and international economies. We believe that we will benefit from marketing and advertising expenditures being moved from other advertising media to the targeted media space, the results of which can be more effectively tracked, enabling measurement of the return on marketing investment. Standard postage rates increased in January of 2006 and again in May of 2007. Postage rates influence the demand for our Direct Marketing services even though the cost of mailings is borne by our clients and is not directly reflected in our revenues or expenses. While we do not expect the postal rate increases to have a significant impact on our Direct Marketing business, there is no assurance that future postal increases will not have an adverse impact on us.

*Operating Expenses*

Operating expenses increased \$4.9 million, or 3.4%, in the second quarter of 2007 compared to the second quarter of 2006. These results were affected by \$2.4 million of operating expense recognized in the second quarter of 2006 as a result of the contract termination discussed above. Excluding the expenses related to the contract termination, operating expense increased \$7.3 million, or 5.1%. These results were also affected by approximately \$1 million of costs, primarily severance and lease termination costs, recognized towards the end of

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the second quarter of 2007 as part of an initiative to reduce fixed costs and headcount. Labor costs increased \$5.2 million, or 7.1%, in the second quarter of 2007 compared to the second quarter of 2006 due to severance and higher payrolls and temporary labor due to more labor intensive revenues. This increase was partially offset by lower incentive compensation. Production and distribution costs decreased \$3.4 million, or 6.3%, due to lower logistics-related transportation costs and less expense related to printing materials. This decrease was partially offset by costs associated with the early termination of a lease as part of the cost cutting initiative. The shift in revenues from high production cost, less labor intensive work done at our divested print facility to more labor intensive, lower production cost work done at Aberdeen also contributed to the changes in labor and production and distribution costs. General and administrative expense increased \$2.6 million, or 22.5%, due primarily to increased employee expenses including travel, recruiting and training, and increased bad debt expense due to timing. Depreciation and amortization expense increased \$0.5 million, or 7.5%, due to additional intangible amortization related to 2006 acquisitions, primarily Aberdeen, and additional depreciation of assets related to our facility in Manila.

Direct Marketing's largest cost components are labor, outsourced costs and transportation costs. Each of these costs is variable and tends to fluctuate with revenues and the demand for our direct marketing services.

First Half 2007 vs. First Half 2006

*Revenues*

Direct Marketing revenues increased \$7.5 million, or 2.2%, in the first half of 2007 compared to the first half of 2006. These year-over-year comparisons were affected by \$7.0 million of revenue recognized in the second quarter of 2006 relating to the contract termination discussed above. Excluding revenues from this contract termination, first half 2007 revenues would have been up \$14.5 million, or 4.4%, compared to the first half of 2006. Our high tech/telecom vertical, which was helped by our September 2006 acquisition of Aberdeen, was up double digits and our select vertical grew in the high single digits. Our retail vertical was up slightly, while our pharma/healthcare vertical was down slightly in the first half. Excluding impact of the contract termination fee, our financial vertical was down in the mid-single digits.

From a service offering perspective, Direct Marketing experienced increased revenues from telesales, market research and analytics, software programming and fulfillment. Partially offsetting these increases were declines in revenues from print and data and database processing.

The acquisitions of StepDot Software GmbH in June 2006, Global Address in July 2006 and Aberdeen in September 2006 positively affected our revenues in the first half of 2007 compared to the first half of 2006. The sale of a print operation in October 2006 negatively affected our revenues in the first half of 2007 compared to the first half of 2006.

*Operating Expenses*

Operating expenses increased \$11.7 million, or 4.1%, in the first half of 2007 compared to the first half of 2006. These results were affected by \$2.4 million of operating expense recognized in the second quarter of 2006 as a result of the contract termination discussed above. Excluding the expenses related to the contract termination, operating expense increased \$14.1 million, or 4.9%. The results were also affected by approximately \$1 million of costs, primarily severance and lease termination costs, recognized towards the end of the second quarter of 2007 as part of an initiative to reduce fixed costs and headcount. Labor costs increased \$12.7 million, or 8.7%, in the first half of 2007 compared to the first half of 2006 due to severance and higher payrolls and temporary labor due to the relative increase in revenues from more labor intensive service lines. Production and distribution costs decreased \$6.8 million, or 6.3%, due to lower logistics-related transportation costs and less expense related to printing materials. This decrease was partially offset by costs associated with the early termination of a lease as part of the cost cutting initiative. The shift in revenues from high production cost, less labor intensive work done at our divested print facility to more labor intensive, lower production cost work done at Aberdeen also

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contributed to the changes in labor and production and distribution costs. General and administrative expense increased \$3.9 million, or 16.7%, due primarily to increased employee expenses including travel, recruiting and training, and bad debt expense due to timing. Depreciation and amortization expense increased \$1.9 million, or 15.7%, due to additional intangible amortization related to 2006 acquisitions, primarily Aberdeen, and additional depreciation of assets related to our facility in Manila.

**Shoppers**

Shoppers operating results were as follows:

| In thousands       | Three months ended |               |        | Six months ended |               |        |
|--------------------|--------------------|---------------|--------|------------------|---------------|--------|
|                    | June 30, 2007      | June 30, 2006 | Change | June 30, 2007    | June 30, 2006 | Change |
| Revenues           | \$ 115,673         | \$ 124,564    | -7.1%  | \$ 227,528       | \$ 238,641    | -4.7%  |
| Operating expenses | 95,329             | 98,290        | -3.0%  | 188,439          | 190,441       | -1.1%  |
| Operating income   | \$ 20,344          | \$ 26,274     | -22.6% | \$ 39,089        | \$ 48,200     | -18.9% |

**2<sup>nd</sup> Quarter 2007 vs. 2<sup>nd</sup> Quarter 2006***Revenues*

Shoppers revenues decreased \$8.9 million, or 7.1%, in the second quarter of 2007 compared to the second quarter of 2006. The decrease in revenues was the result of decreased sales in established markets and the discontinuation of commercial printing operations in our Tampa facility. Our Shoppers business continues to be impacted by the difficult economic environments in California and Florida. While we believe this environment is primarily attributable to the condition of the real estate and associated financing markets in the California and Florida geographies in which we operate, the impact is affecting virtually all revenue categories. As a result we shut down approximately 600,000 of unprofitable circulation at the end of June 2007. This circulation represented approximately \$1.5 million of revenue in the second quarter of 2007. After this reduction, our Shoppers circulation reached approximately 13 million in California and Florida each week. We will continue to evaluate all of our circulation performance, but do not anticipate further circulation reductions of this magnitude in the near future. Despite this circulation reduction, we continue to believe that future expansions may provide increased revenue opportunities in the long term. As our recent results reflect, 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 than mature areas or even unprofitable until the publications in those areas mature.

*Operating Expenses*

Operating expenses decreased \$3.0 million, or 3.0%, in the second quarter of 2007 compared to the second quarter of 2006. This decrease was partially offset by approximately \$1.0 million of costs recognized in the quarter related to the circulation shut down described above. Total labor costs decreased \$1.7 million, or 4.8%, due to lower incentive compensation and sales commissions related to the revenue decline. This decline was partially offset by severance and other labor costs associated with the circulation reduction. Total production costs decreased \$2.2 million, or 4.2%, due primarily to decreased paper costs resulting from the discontinuation of commercial printing operations in our Tampa facility and the overall decline in revenues, and decreased postage costs due to a decline in distribution revenues. This decrease was partially offset by costs incurred to terminate a lease related to the circulation reduction. Total general and administrative costs increased \$0.7 million, or 7.8%, due to higher bad debt expense due to timing, and higher insurance costs due to workers compensation experience. Depreciation and amortization expense increased \$0.2 million, or 10.6%, due to increased capital expenditures in recent years to support growth and the write-off of assets related to the circulation shut down.

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. Standard postage rates increased in



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January 2006. Standard postage rates increased again in May 2007. However, we changed the manner in which we address our Shoppers publications from detached cards to individual labels, and as a result our per-piece postage rates remained steady when the May 2007 rates were put in effect. Paper prices, which had been increasing since 2004, declined in the second quarter of 2007, resulting in lower production costs. Paper prices are expected to continue to decline over the second half of 2007, which will affect Shoppers' production costs. As discussed above, at the end of June 2007 we shut down approximately 600,000 of circulation.

**First Half 2007 vs. First Half 2006**

*Revenues*

Shoppers revenues decreased \$11.1 million, or 4.7%, in the first half of 2007 compared to the first half of 2006. The decrease in revenues was the result of decreased sales in established markets and the discontinuation of commercial printing operations in our Tampa facility. Our Shoppers business continues to be impacted by the difficult economic environments in California and Florida. While we believe this environment is primarily attributable to the condition of the real estate and associated financing markets in the California and Florida geographies in which we operate, the impact is affecting virtually all revenue categories. The 600,000 circulation reduction discussed above represented approximately \$3.0 million of revenue in the first half of 2007.

*Operating Expenses*

Operating expenses decreased \$2.0 million, or 1.1%, in the first half of 2007 compared to the first half of 2006. This decrease was partially offset by approximately \$1.0 million of costs recognized in the second quarter related to the circulation shut down described above. Total labor costs decreased \$0.5 million, or 0.7%, due to lower incentive compensation and sales commissions related to the revenue decline. This decline was partially offset by severance and other labor costs associated with the circulation reduction. Total production costs decreased \$0.6 million, or 0.6%, due primarily to decreased paper costs resulting from the discontinuation of commercial printing operations in our Tampa facility and the overall decline in revenues, and decreased offload printing costs due to decreased print-and-deliver volumes. This decrease was partially offset by costs incurred to terminate a lease related to the circulation reduction. Total general and administrative costs decreased \$1.2 million, or 7.0%, due to lower promotion costs and lower employee expenses including recruiting, travel, and training. Depreciation and amortization expense increased \$0.3 million, or 7.9%, due to increased capital expenditures in recent years to support growth and the write-off of assets related to the circulation shut down.

**General Corporate Expense**

General corporate expense decreased \$0.2 million, or 6.2%, during the second quarter of 2007 compared to the second quarter of 2006 due to lower incentive compensation.

General corporate expense increased \$0.1 million, or 1.9%, during the first half of 2007 compared to the first half of 2006 due to increased employee expenses, primarily recruiting.

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### **Interest Expense**

Interest expense was up \$2.3 million, or 222.1% in the second quarter of 2007 and \$4.4 million or 235.0% in the first half of 2007 compared to the same periods in 2006. These increases are due to higher outstanding debt levels, primarily due to the repurchases of our common stock, 2006 acquisitions, and higher interest rates on borrowings in 2007 than 2006.

### **Interest Income**

Interest income was up slightly in the second quarter and up \$0.2 or 173.9% in the first half of 2007 compared to the same periods in 2006 due to normal variances in cash levels and higher interest rates on investments.

### **Other Income and Expense**

Other net expense primarily consists of stockholder expenses and balance-based bank charges.

### **Income Taxes**

Income tax expense decreased \$4.7 million in the second quarter of 2007 and \$6.5 million in the first half of 2007 compared to the same periods in 2006. The effective tax rate was 40.1% for the second quarter of 2007, up from 39.8% for the second quarter of 2006. The effective tax rate was 39.5% for the first half of 2007, up from 39.1% for the first half of 2006. For the full year 2007, we expect our effective tax rate to be 100 basis points higher than our effective tax rate for 2006, primarily as a result of a favorable resolution of a state tax matter in the third quarter of 2006 which lowered our effective tax rate in that quarter.

### **Liquidity and Capital Resources**

#### *Sources and Uses of Cash*

As of June 30, 2007, cash and cash equivalents were \$34.0 million, decreasing \$4.3 million from cash and cash equivalents at December 31, 2006. This net decrease was a result of net cash provided by operating activities of \$76.5 million, offset by cash used in investing activities of \$13.8 million and net cash used in financing activities of \$67.2 million.

#### *Operating Activities*

Net cash provided by operating activities for the six months ended June 30, 2007 was \$76.5 million, compared to \$77.3 million for the first six months of 2006. The \$0.8 million year-over-year decrease was attributable to lower net income, partially offset by changes within working capital assets and liabilities.

For the six months ended June 30, 2007 our principal working capital changes, which directly affected net cash provided by operating activities, were as follows:

A decrease in accounts receivable attributable to lower revenues in the first half of 2007 than in the first half of 2006 and a higher beginning year accounts receivable balance. Days sales outstanding of approximately 54 days at June 30, 2007 decreased from 56 days at December 31, 2006 and increased from 53 days at June 30, 2006;

A decrease in inventory due to sales of paper inventory related to the print operation that was sold in October 2006;

A decrease in prepaid expenses and other current assets due to timing of payments;

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An increase in accounts payable due to higher insurance reserves and timing of payments;

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A decrease in accrued payroll and related expenses due to payment of 2006 bonuses;

An increase in customer deposits and unearned revenue due to timing of receipts; and

A decrease in income taxes payable due to the timing of quarterly estimated federal and state taxes payments.

*Investing Activities*

Net cash used in investing activities was \$13.8 million for the first half of 2007, compared to \$20.4 million for the first half of 2006. The difference is the result of less capital spending and acquisition related expenditures in the first six months of 2007 than in the first six months of 2006.

*Financing Activities*

Net cash outflows from financing activities were \$67.2 million for the six months ended June 30, 2007 compared to net cash outflows of \$54.7 million for the six months ended June 30, 2006. The difference is attributable primarily to spending \$13.1 million more to repurchase our common stock in the first half of 2007 than in the first half of 2006.

We consider such factors as current assets, current liabilities, total debt, revenues, operating income and cash flows from operations, investing activities and financing activities when assessing our liquidity. Our primary sources of liquidity have been cash and cash equivalents on hand and cash generated from operating activities. Our management of cash is designed to optimize returns on cash balances and to ensure that it is readily available to meet our operating, investing and financing requirements as they arise. Capital resources are also available from and provided through our unsecured credit facilities, a five-year \$125 million revolving credit facility (the Revolving Credit Facility ) entered into on August 12, 2005 and a five-year \$195 million term loan facility (the Term Loan Facility ) entered into on September 6, 2006, subject to the terms and conditions of these facilities.

Based on our current operational plans, we believe that our Revolving Credit Facility, together with cash provided by operating activities, will be sufficient to fund operations and anticipated capital expenditures, payments of principal and interest on our borrowings and dividends on our common stock for at least the next twelve months. As of June 30, 2007, we had \$108.0 million of unused borrowing capacity under our Revolving Credit Facility. As of June 30, 2007, we did not have any unused borrowing capacity under our Term Loan Facility.

**Critical Accounting Policies**

Our financial statements and accompanying notes are prepared in accordance with U.S generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. These estimates and assumptions are affected by management's application of accounting policies. We consider the following to be our critical accounting policies:

Revenue recognition;

Allowance for doubtful accounts;

Reserve for healthcare, workers' compensation, automobile and general liability;

Goodwill; and

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Stock-based compensation.

There have been no material changes to the critical accounting policies described in our 2006 Form 10-K.

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**Recent Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes, by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. An enterprise would be required to recognize in its financial statements the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement only if that position meets the more-likely-than-not recognition threshold. We adopted the provisions of FIN 48 on January 1, 2007. We did not recognize a change to our unrecognized tax benefits as a result of this adoption.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158), an amendment of FASB Statements No. 87 (SFAS 87), 88 (SFAS 88), 106 (SFAS 106), and 132R (SFAS 132R) and other related accounting literature. SFAS 158 requires an employer to recognize the overfunded or underfunded status of defined benefit postretirement plans as an asset or a liability in its statement of financial position. The funded status is measured as the difference between plan assets at fair value and the benefit obligation (the projected benefit obligation for pension plans or the accumulated benefit obligation for other postretirement benefit plans). An employer is also required to measure the funded status of a plan as of the date of its year-end balance sheet with changes in the funded status recognized through comprehensive income. As a result of the adoption of SFAS 158 as of December 31, 2006, we recorded a noncurrent liability, representing the combined underfunded status of our pension plans, of \$18.2 million dollars on our year end 2006 consolidated balance sheet.

In June 2007, the FASB's Emerging Issues Task Force (EITF) issued EITF 06-11, Tax Benefits from Dividends on Nonvested Stock and Option Awards. EITF 06-11 requires the tax benefit received on dividends associated with share-based awards that are charged to retained earnings to be recorded in additional paid-in capital and included in the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards. Our adoption of EITF 06-11 on January 1, 2008 is not expected to have a material impact on our consolidated financial statements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to various market risks, including interest rates on our debt and under a deferred compensation agreement and foreign exchange rates, and we monitor these risks throughout the normal course of business. As of June 30, 2007, we did not have any interest rate or foreign exchange hedging instruments in place.

Our earnings are affected by changes in short-term interest rates as a result of our Revolving Credit Facility and Term Loan Facility, both of which bear interest at variable rates based on Eurodollar rates (effective rate of 5.64% at June 30, 2007). At June 30, 2007, we had \$17.0 million of debt outstanding under our Revolving Credit Facility, which has a maturity date of August 12, 2010, and \$195.0 million of debt outstanding under our Term Loan Facility, which has a final maturity date of September 6, 2011. Our earnings are also affected by changes in short-term interest rates as a result of a deferred compensation agreement with our former Chief Executive Officer, which bears interest at variable rates based on Prime (effective rate of 8.25% at June 30, 2007) and has a balance of \$5.6 million at June 30, 2007. Assuming the actual level of borrowing and deferred compensation balance throughout the second quarter and first half of 2007 and assuming a one percentage point increase in average interest rates, it is estimated that our net income for the quarter and six months ended June 30, 2007 would have changed by approximately \$0.3 million and \$0.6 million, respectively. Due to our overall debt level and deferred compensation balance at June 30, 2007, anticipated cash flows from operations, and the various financial alternatives available to management should there be an adverse change in interest rates, we do not

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believe that we have significant exposure to market risks associated with changing interest rates.

Our earnings are also affected by fluctuations in foreign exchange rates as a result of our operations in foreign countries, a portion of which are conducted in foreign currencies. Due to the level of operations in foreign countries, we do not believe that the impact of fluctuations in foreign exchange rates is significant to our overall earnings.

**Item 4. Controls and Procedures**

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, or the Exchange Act). It should be noted that, because of inherent limitations, our disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the disclosure controls and procedures are met. Based upon that evaluation, the Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer concluded that the design and operation of these disclosure controls and procedures were effective, at the reasonable assurance level, to ensure information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer, of our internal control over financial reporting to determine whether any changes occurred during the second quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there were no changes in our internal control over financial reporting or in other factors that have materially affected or are reasonably likely to materially affect our internal control over financial reporting. We may make changes in our internal control processes from time to time in the future. It should also be noted that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements, and controls may become inadequate because of changes in conditions or in the degree of compliance with the policies or procedures.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are subject to various legal proceedings in the course of conducting our businesses and, from time to time, may become involved in other claims and lawsuits incidental to our businesses. In the opinion of management, after consultation with counsel, any ultimate liability arising out of currently pending claims and lawsuits is not currently expected to have a material adverse effect on our consolidated financial position or results of operations. Nevertheless, we cannot predict the impact of future developments affecting our pending claims and lawsuits.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our 2006 Form 10-K, which could materially affect our business, financial condition or future results. The risks described in our 2006 Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and operating results. In our judgment,

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there were no material changes in the risk factors as previously disclosed in Part I, Item 1A. Risk Factors of our 2006 Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table contains information about our purchases of equity securities during the second quarter of 2007:

| Period             | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of a Publicly Announced Plan <sup>(1)</sup> |  | Maximum Number of Shares that May Yet Be Purchased Under the Plan |
|--------------------|----------------------------------|------------------------------|--|--|---|
|                    |                                  |                              |  |  |   |
| April 1 30, 2007   | 1,121,900                        | \$ 26.98                     | 1,121,900  |  | 2,939,591   |
| May 1 31, 2007 (2) | 280,700                          | \$ 25.98                     | 280,700  |  | 8,658,891   |
| June 1 30, 2007    | 225,000                          | \$ 25.66                     | 225,000  |  | 8,433,891   |
| Total              | 1,627,600                        | \$ 26.62                     | 1,627,600  |  |   |

(1) During the second quarter of 2007, 1,627,600 shares were purchased through our stock repurchase program that was publicly announced in January 1997. Under this program, from which shares can be purchased in the open market or through privately negotiated transactions, our Board of Directors authorized the repurchase of up to 61,900,000 shares of our outstanding common stock. As of June 30, 2007, we had repurchased a total of 53,466,109 shares at an average price of \$19.07 per share under this program.

(2) In May 2007, our Board of Directors increased our repurchase authorization by 6,000,000 shares.

**Item 4. Submission of Matters to a Vote of Security Holders**

We held our annual meeting of stockholders on May 15, 2007. At the meeting the stockholders were requested to vote on the election of the three class II directors listed below. The result of the vote was as follows:

|                   | For        | Withheld  |
|-------------------|------------|-----------|
| William F. Farley | 69,409,112 | 1,728,758 |
| Larry Franklin    | 63,386,881 | 7,750,989 |
| William K. Gayden | 70,069,903 | 1,067,967 |

**Item 6. Exhibits**

See Index to Exhibits on Page 27.



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Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

|                        |   |
|------------------------|---|
|                        | HARTE-HANKS, INC.   |
| August 9, 2007<br>Date | /s/ Richard M. Hochhauser<br>Richard M. Hochhauser<br>Chief Executive Officer                     |
| August 9, 2007<br>Date | /s/ Dean H. Blythe<br>Dean H. Blythe<br>President and Chief Financial Officer                     |
| August 9, 2007<br>Date | /s/ Jessica M. Huff<br>Jessica M. Huff<br>Vice President, Finance and<br>Chief Accounting Officer |

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**Exhibit No.    Description of Exhibit**

|       |   |
|-------|---|
| *31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| *31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| *32.1 | Furnished Certification of Chief Executive Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| *32.2 | Furnished Certification of Chief Financial Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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\* Filed or furnished herewith