

HARTE HANKS INC  
Form 10-Q  
May 10, 2006  
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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 March 31, 2006

**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 (as defined in Exchange Act Rule 12b-2).

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock: \$1 par value per share, 80,815,736 shares as of April 30, 2006.

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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 share amounts)

|  | (Unaudited)       |                   |
|--|-------------------|-------------------|
|  | March 31,         | December 31,      |
|  | 2006              | 2005              |
| <b>Assets</b>  |                   |                   |
| Current assets   |                   |                   |
| Cash and cash equivalents  | \$ 17,354         | \$ 24,561         |
| Accounts receivable, net   | 168,422           | 184,537           |
| Inventory  | 9,166             | 7,947             |
| Prepaid expenses   | 18,217            | 14,783            |
| Current deferred income tax asset  | 14,332            | 14,158            |
| Other current assets   | 10,248            | 7,718             |
| <b>Total current assets</b>  | <b>237,739</b>    | <b>253,704</b>    |
| Property, plant and equipment, net   | 115,929           | 112,911           |
| Goodwill, net  | 502,750           | 502,750           |
| Other intangible assets, net   | 16,307            | 16,669            |
| Other assets   | 3,382             | 3,629             |
| <b>Total assets</b>  | <b>\$ 876,107</b> | <b>\$ 889,663</b> |
| <b>Liabilities and Stockholders' Equity</b>  |                   |                   |
| Current liabilities  |                   |                   |
| Accounts payable   | 57,266            | 62,978            |
| Accrued payroll and related expenses   | 20,995            | 35,735            |
| Customer deposits and unearned revenue   | 56,627            | 54,143            |
| Income taxes payable   | 22,843            | 12,710            |
| Other current liabilities  | 9,686             | 9,781             |
| <b>Total current liabilities</b>   | <b>167,417</b>    | <b>175,347</b>    |
| Long-term debt   | 50,000            | 62,000            |
| Other long-term liabilities  | 92,126            | 90,970            |
| <b>Total liabilities</b>   | <b>309,543</b>    | <b>328,317</b>    |
| <b>Stockholders' equity</b>  |                   |                   |
| Common stock, \$1 par value per share, 250,000,000 shares authorized. 115,910,179 and 115,453,416 shares issued at March 31, 2006 and December 31, 2005 respectively | 115,910           | 115,453           |
| Additional paid-in capital   | 280,735           | 269,865           |
| Retained earnings  | 999,530           | 980,505           |
| Less treasury stock: 34,873,345 and 33,965,335 shares at cost at March 31, 2006 and December 31, 2005, respectively  | (807,938)         | (782,495)         |
| Accumulated other comprehensive loss   | (21,673)          | (21,982)          |
| <b>Total stockholders' equity</b>  | <b>566,564</b>    | <b>561,346</b>    |

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|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 876,107 | \$ 889,663 |
|--|------------|------------|

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 March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2006</b>                         | <b>2005</b> |
| Operating revenues   | \$ 278,395                          | \$ 268,293  |
| Operating expenses   |                                     |             |
| Labor  | 107,919                             | 104,302     |
| Production and distribution                                      | 101,851                             | 93,588      |
| Advertising, selling, general and administrative                 | 21,238                              | 20,612      |
| Depreciation and amortization                                    | 7,455                               | 7,322       |
| Intangible amortization  | 362                                 | 150         |
| Total operating expenses   | 238,825                             | 225,974     |
| Operating income   | 39,570                              | 42,319      |
| Other expenses (income)  |                                     |             |
| Interest expense   | 855                                 | 203         |
| Interest income  | (26)                                | (78)        |
| Other, net   | 264                                 | 489         |
|  | 1,093                               | 614         |
| Income before income taxes                                       | 38,477                              | 41,705      |
| Income tax expense   | 14,694                              | 16,632      |
| Net income   | \$ 23,783                           | \$ 25,073   |
| Basic earnings per common share                                  | \$ 0.29                             | \$ 0.30     |
| Weighted-average common shares outstanding                       | 81,322                              | 84,730      |
| Diluted earnings per common share                                | \$ 0.29                             | \$ 0.29     |
| Weighted-average common and common equivalent shares outstanding | 83,028                              | 86,424      |

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>Three Months Ended March 31,</b> |                  |
|---|-------------------------------------|------------------|
|   | <b>2006</b>                         | <b>2005</b>      |
| <b>Cash Flows from Operating Activities</b>                                   |                                     |                  |
| Net income  | \$ 23,783                           | \$ 25,073        |
| Adjustments to reconcile net income to cash provided by operating activities: |                                     |                  |
| Depreciation and amortization   | 7,455                               | 7,322            |
| Intangible amortization   | 362                                 | 150              |
| Stock-based compensation  | 1,764                               | 26               |
| Excess tax benefits from stock-based compensation                             | (1,946)                             |                  |
| Deferred income taxes   | 758                                 | 382              |
| Other, net  | 23                                  | 303              |
| Changes in operating assets and liabilities, net of acquisitions:             |                                     |                  |
| Decrease (increase) in accounts receivable, net                               | 16,115                              | (1,047)          |
| (Increase) decrease in inventory  | (1,219)                             | 789              |
| Increase in prepaid expenses and other current assets                         | (5,964)                             | (2,874)          |
| Decrease in accounts payable  | (5,712)                             | (1,135)          |
| (Decrease) increase in other accrued expenses and other current liabilities   | (1,529)                             | 8,087            |
| Other, net  | 866                                 | 892              |
| <b>Net cash provided by operating activities</b>                              | <b>34,756</b>                       | <b>37,968</b>    |
| <b>Cash Flows from Investing Activities</b>                                   |                                     |                  |
| Acquisitions, net of cash acquired  |                                     | (1,492)          |
| Purchases of property, plant and equipment                                    | (10,442)                            | (8,677)          |
| Proceeds from sale of property, plant and equipment                           | 45                                  | 1                |
| <b>Net cash used in investing activities</b>                                  | <b>(10,397)</b>                     | <b>(10,168)</b>  |
| <b>Cash Flows from Financing Activities</b>                                   |                                     |                  |
| Long-term borrowings  | 38,000                              |                  |
| Repayment of long-term borrowings   | (50,000)                            | (10,000)         |
| Issuance of common stock  | 6,115                               | 2,995            |
| Purchase of treasury stock  | (22,938)                            | (17,126)         |
| Issuance of treasury stock  | 44                                  | 44               |
| Excess tax benefits from stock-based compensation                             | 1,946                               |                  |
| Dividends paid  | (4,758)                             | (4,238)          |
| <b>Net cash used in financing activities</b>                                  | <b>(31,591)</b>                     | <b>(28,325)</b>  |
| Effect of exchange rate changes on cash and cash equivalents                  | 25                                  |                  |
| Net decrease in cash and cash equivalents                                     | (7,207)                             | (525)            |
| Cash and cash equivalents at beginning of year                                | 24,561                              | 38,807           |
| <b>Cash and cash equivalents at end of period</b>                             | <b>\$ 17,354</b>                    | <b>\$ 38,282</b> |

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)

(2006 Unaudited)

|  | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Treasury<br>Stock | Accumulated                             |                                  |
|--|-----------------|----------------------------------|----------------------|-------------------|---|----------------------------------|
|  |                 |                                  |                      |                   | Other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders'<br>Equity |
| Balance at January 1, 2005                                       | \$ 114,505      | \$ 253,515                       | \$ 882,750           | \$ (663,779)      | \$ (15,192)                             | \$ 571,799                       |
| Common stock issued-employee benefit plans                       | 174             | 3,874                            |                      |                   |   | 4,048                            |
| Exercise of stock options for cash and by surrender of shares    | 774             | 7,311                            |                      | (4,654)           |   | 3,431                            |
| Tax benefit of options exercised                                 |                 | 5,133                            |                      |                   |   | 5,133                            |
| Dividends paid (\$0.20 per share)                                |                 |                                  | (16,703)             |                   |   | (16,703)                         |
| Treasury stock repurchased                                       |                 |                                  |                      | (114,213)         |   | (114,213)                        |
| Treasury stock issued  |                 | 32                               |                      | 151               |   | 183                              |
| Comprehensive income, net of tax:                                |                 |                                  |                      |                   |   |                                  |
| Net income   |                 |                                  | 114,458              |                   |   | 114,458                          |
| Adjustment for minimum pension liability (net of tax of \$3,567) |                 |                                  |                      |                   | (5,450)                                 | (5,450)                          |
| Foreign currency translation adjustment                          |                 |                                  |                      |                   | (1,340)                                 | (1,340)                          |
| Total comprehensive income                                       |                 |                                  |                      |                   |   | 107,668                          |
| Balance at December 31, 2005                                     | \$ 115,453      | \$ 269,865                       | \$ 980,505           | \$ (782,495)      | \$ (21,982)                             | \$ 561,346                       |
| Common stock issued-employee benefit plans                       | 46              | 1,037                            |                      |                   |   | 1,083                            |
| Exercise of stock options for cash and by surrender of shares    | 411             | 5,328                            |                      | (2,543)           |   | 3,196                            |
| Tax benefit of options exercised                                 |                 | 2,224                            |                      |                   |   | 2,224                            |
| Stock-based compensation   |                 | 2,275                            |                      |                   |   | 2,275                            |
| Dividends paid (\$0.06 per share)                                |                 |                                  | (4,758)              |                   |   | (4,758)                          |
| Treasury stock repurchased                                       |                 |                                  |                      | (22,938)          |   | (22,938)                         |
| Treasury stock issued  |                 | 6                                |                      | 38                |   | 44                               |
| Comprehensive income, net of tax:                                |                 |                                  |                      |                   |   |                                  |
| Net income   |                 |                                  | 23,783               |                   |   | 23,783                           |
| Foreign currency translation adjustment                          |                 |                                  |                      |                   | 309                                     | 309                              |
| Total comprehensive income                                       |                 |                                  |                      |                   |   | 24,092                           |
| Balance at March 31, 2006  | \$ 115,910      | \$ 280,735                       | \$ 999,530           | \$ (807,938)      | \$ (21,673)                             | \$ 566,564                       |

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 accounting principles generally accepted in the United States of America 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 ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. 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, 2005.

Certain prior period amounts have been reclassified for comparative purposes.

**Note B - Income Taxes**

Our first quarter income tax provision of \$14.7 million was calculated using an effective income tax rate of approximately 38.2%. Our effective income tax rate is derived by estimating pretax income and income tax expense for the year ending December 31, 2006. 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.

**Note C - Stock-Based Compensation**

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123, as revised, Share-Based Payment (SFAS No. 123R). SFAS No. 123R requires that all share-based awards be recognized as operating expense, based on their fair values on the date of grant, over the requisite service period, in the consolidated statement of operations. Prior to January 1, 2006, we accounted for share-based awards under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and related interpretations. Accordingly, prior to January 1, 2006 no compensation expense was recognized for share-based awards granted where the exercise price was equal to the market price of the underlying stock on the date of grant.

We have elected to adopt SFAS No. 123R under the modified-prospective transition method and we have not restated prior periods in the consolidated financial statements. Under this transition method, stock-based compensation expense for the first quarter of 2006 includes:

1. Compensation expense for all stock options granted prior to, but not vested as of, December 31, 2005, based on the fair value estimated at grant date in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation ;
2. Compensation expense for all stock options granted subsequent to December 31, 2005, based on fair value estimated at the grant date in accordance with SFAS No. 123R;

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3. Compensation expense for all nonvested share awards in accordance with SFAS No. 123R;
4. Compensation expense for all performance stock unit awards in accordance with SFAS No. 123R; and

5. Compensation expense for the 15% discount from market value for shares purchased under our Employee Stock Purchase Plan. We estimated forfeitures in calculating stock-based compensation expense for both the stock-based awards granted prior to, but not vested as of January 1, 2006, as well as stock-based awards granted subsequent to January 1, 2006.

Compensation expense for stock-based awards is recognized in the Labor line of the consolidated statement of operations. For the quarters ended March 31, 2006 and March 31, 2005, we recorded total stock-based compensation expense of \$1,764,000 (\$1,090,000, net of tax) and \$26,000 (\$16,000, net of tax), respectively. Included in this total stock-based compensation expense is incremental expense for stock-based compensation, as a result of the adoptions of SFAS No. 123R, of \$1,751,000 (\$1,082,000, net of tax) for the quarter ended March 31, 2006. For periods prior to the adoption of SFAS No. 123R, we followed APB No. 25 and recorded stock-based compensation expense only for stock options granted where the exercise price was less than the market price of the underlying stock on the date of grant.

We are required to reflect the benefits of tax deductions in excess of recognized compensation expense as both a financing cash inflow and an operating cash outflow upon adoption of SFAS No. 123R. The adoption of SFAS No. 123R did not have a material effect on cash flow for the three months ended March 31, 2006.

The following table illustrates the effect on net income and earnings per share as if we had applied the fair value recognition provisions of SFAS No. 123R to stock-based compensation for all periods presented:

| <b>In thousands, except per share amounts</b>  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2006</b>                         | <b>2005</b> |
| Net income as reported   | \$ 23,783                           | \$ 25,073   |
| Stock-based employee compensation expense, included in reported net income, net of related tax effects                         | 1,090                               | 16          |
| Stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects | (1,090)                             | (1,109)     |
| Net income pro forma   | \$ 23,783                           | \$ 23,980   |
| Basic earnings per share as reported   | \$ 0.29                             | \$ 0.30     |
| Basic earnings per share pro forma   | \$ 0.29                             | \$ 0.28     |
| Diluted earnings per share as reported   | \$ 0.29                             | \$ 0.29     |
| Diluted earnings per share pro forma   | \$ 0.29                             | \$ 0.28     |

In November 2005, the Financial Accounting Standards Board (FASB) issued Staff Position (FSP) SFAS No. 123R-3, Transition Election to Accounting for the Tax Effects of Share Based Payment Awards. This FSP

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requires an entity to follow either the transition guidance for the additional paid-in capital pool as described in SFAS No. 123R, or the alternative transition method as described in this FSP. An entity that adopts SFAS No. 123R using the modified prospective application may make a one-time election to adopt the transition method described in this FSP. We have elected to adopt the transition method described in this FSP.

In May 2005 we adopted the 2005 Omnibus Incentive Plan (2005 Plan), a shareholder approved plan, pursuant to which we may issue to directors, officers and key employees up to 4,570,000 equity securities. Under the 2005 Plan we have awarded stock options, nonvested shares and performance stock units. The 2005 Plan replaced the 1991 Stock Option Plan (1991 Plan), a shareholder approved plan, pursuant to which we issued stock options to officers and key employees. No additional options will be granted under the 1991 Plan. As of March 31, 2006, there were 3,637,232 shares available for grant under the 2005 Plan.

### Stock Options

Under the 2005 Plan, all options have been granted at exercise prices equal to the market price of the common stock on the grant date (2005 Plan market price options). All 2005 Plan market price options become exercisable in 25% increments on the second, third, fourth and fifth anniversaries of their date of grant and expire on the tenth anniversary of their date of grant. As of March 31, 2006, 2005 Plan market price options to purchase 814,625 shares were outstanding with exercise prices ranging from \$25.76 to \$29.05 per share. There were no exercisable 2005 Plan market price options at March 31, 2006.

Under the 1991 Plan, options were granted at exercise prices equal to the market price of the common stock on the grant date (1991 Plan market price options) and at exercise prices below the market price of the common stock (1991 Plan performance options). 1991 Plan market price options granted prior to January 1998 became exercisable after the fifth anniversary of their date of grant and expire on the tenth anniversary of their date of grant. Beginning January 1998, 1991 Plan market price options become exercisable in 25% increments on the second, third, fourth and fifth anniversaries of their date of grant and expire on the tenth anniversary of their date of grant. As of March 31, 2006, 1991 Plan market price options to purchase 6,781,285 shares were outstanding with exercise prices ranging from \$8.54 to \$26.88 per share.

At March 31, 2006, 1991 Plan performance options to purchase 62,100 shares were outstanding with exercise prices ranging from \$0.67 to \$1.33 per share. No 1991 Plan performance options have been granted since January 1999. The 1991 Plan performance options became exercisable in whole or in part after three years, and the extent to which they became exercisable at that time depended upon the extent to which we achieved certain goals established at the time the options were granted. In December 2005 the remaining unvested 1991 Plan performance options were amended to comply with Section 409A of the Internal Revenue Code of 1986, as amended. Under this option amendment, these unvested 1991 Plan performance options will only be exercisable on the business day following the vesting date of each option.

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The following summarizes all stock option activity during the three months ended March 31, 2006:

|  | Number    | Weighted-Average | Weighted-Remaining Contractual Term (Years) | Aggregate Intrinsic Value (Thousands) |
|--|-----------|------------------|---|---------------------------------------|
| Options outstanding at January 1, 2006 | 7,428,184 | \$ 18.07         |   |                                       |
| Granted                                | 712,125   | 25.80            |   |                                       |
| Exercised                              | (413,464) | 13.39            |   |                                       |
| Cancelled                              | (68,835)  | 22.82            |   |                                       |
| Options outstanding at March 31, 2006  | 7,658,010 | \$ 19.00         | 6.03  | \$ 63,944                             |
| Exercisable at March 31, 2006          | 4,161,348 | \$ 15.35         | 4.18  | \$ 49,936                             |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model based on the following weighted-average assumptions used for grants during the three months ended March 31, 2006 and 2005:

|                                 | Three Months Ended March 31, |        |
|---------------------------------|------------------------------|--------|
|                                 | 2006                         | 2005   |
| Expected term (in years)        | 6.75                         | 6.59   |
| Expected stock price volatility | 23.80%                       | 25.70% |
| Risk-free interest rate         | 4.43%                        | 4.00%  |
| Expected dividend yield         | 0.89%                        | 0.75%  |

Expected term is estimated using the simplified method under Staff Accounting Bulletin 107, which takes into account vesting and contractual term. Expected stock price volatility is based on the historical volatility from traded shares of our stock over the expected term. The risk-free interest rate is based on the rate of a zero-coupon U.S. Treasury instrument with a remaining term approximately equal to the expected term. Expected dividend yield is based on historical stock price volatility and anticipated future annual dividends over the expected term. Future annual dividends over the expected term are estimated to range between \$0.24 and \$0.48 per share, with a weighted-average annual dividend of \$0.36 per share.

The weighted-average fair value of options granted during the three months ended March 31, 2006 and March 31, 2005 was \$8.16 and \$8.29, respectively. As of March 31, 2006, there was \$15,925,000 of total unrecognized compensation cost related to unvested stock options. This cost is expected to be recognized over a weighted average period of approximately 3.46 years.

The total intrinsic value of options exercised during the three months ended March 31, 2006 and 2005 was \$5,917,000 and \$3,840,000, respectively.

**Nonvested Shares**

In the first quarter of 2006 we granted nonvested shares for the first time. These nonvested shares were granted under the 2005 Plan, and vest 100% on the third anniversary of their date of grant. As of March 31, 2006, 82,274 nonvested shares were outstanding. As of March 31, 2006, none of the nonvested shares granted had vested. In addition, in January 2006, certain officers of the company elected to receive a portion of their 2005 bonus in the form of nonvested shares instead of cash payments. In connection with this election, the value of nonvested shares granted was equal to 125% of the value of the foregone cash payment.



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The following summarizes all nonvested share activity during the three months ended March 31, 2006:

|   | Number<br>Of Shares | Weighted-<br>Average<br>Grant-Date<br>Fair Value |
|---|---------------------|--|
| Nonvested shares outstanding at January 1, 2006 |                     | \$   |
| Granted   | 82,624              | 25.82  |
| Vested  |                     |  |
| Cancelled                                       | (350)               | 25.80  |
| Nonvested shares outstanding at March 31, 2006  | 82,274              | \$ 25.82   |

The fair value of each nonvested share is estimated on the date of grant as the closing market price of our common stock on the date of grant. The weighted-average fair value of nonvested shares granted during the three months ended March 31, 2006 was \$25.82. We did not grant any nonvested shares prior to January 1, 2006. As of March 31, 2006, there was \$1,526,000 of total unrecognized compensation cost related to nonvested shares. This cost is expected to be recognized over a weighted average period of approximately 2.82 years.

**Performance Stock Units**

In the first quarter of 2006 we granted performance stock units for the first time. These performance stock units were granted under the 2005 Plan. Performance stock units are a form of share-based awards in which the number of shares ultimately issued is based on our performance against specific performance goals over a three-year period. At the end of the performance period, the number of shares of stock issued will be determined by adjusting upward or downward from the target in a range between 0% and 125%. As of March 31, 2006, 47,825 performance stock units were outstanding. As of March 31, 2006, no shares of stock associated with the performance stock units awarded have been issued.

The following summarizes all performance stock unit activity during the three months ended March 31, 2006:

|  | Number<br>Of Shares | Weighted-<br>Average<br>Grant-Date<br>Fair Value |
|--|---------------------|--|
| Performance stock units outstanding at January 1, 2006 |                     | \$   |
| Granted  | 48,175              | 25.03  |
| Issued   |                     |  |
| Cancelled  | (350)               | 25.03  |
| Performance stock units outstanding at March 31, 2006  | 47,825              | \$ 25.03   |

The fair value of each performance stock unit is estimated on the date of grant as the closing market price of our common stock on the date of grant, minus the present value of dividend payments anticipated to be paid by the company over the vesting period. Annual dividends over the vesting period are estimated to range between \$0.24 and \$0.32 per share, with a weighted-average annual dividend of \$0.28 per share. Periodic compensation expense is based on the current estimate of future performance against specific performance goals over a three-year period and is adjusted up or down based on those estimates. The weighted-average fair value of





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performance stock units granted during the three months ended March 31, 2006 was \$25.03. As of March 31, 2006, there was \$851,000 of total unrecognized compensation cost related to performance stock units. This cost is expected to be recognized over a weighted average period of approximately 2.82 years.

**Employee Stock Purchase Plan**

The 1994 Employee Stock Purchase Plan (ESPP Plan), a shareholder approved 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. During the three months ended March 31, 2006, we issued 45,499 shares under our employee stock purchase plan at an average price of \$23.51 per share. 2,606,604 shares were available for sale at March 31, 2006.

**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, nonvested shares and performance stock unit awards.

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 March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2006</b>                         | <b>2005</b> |
| <b>BASIC EPS</b>  |                                     |             |
| Net Income  | \$ 23,783                           | \$ 25,073   |
| Weighted-average common shares outstanding used in earnings per share computations      | 81,322                              | 84,730      |
| Earnings per common share   | \$ 0.29                             | \$ 0.30     |
| <b>DILUTED EPS</b>  |                                     |             |
| Net Income  | \$ 23,783                           | \$ 25,073   |
| Shares used in diluted earnings per share computations                                  | 83,028                              | 86,424      |
| Earnings per common share   | \$ 0.29                             | \$ 0.29     |
| <b>Computation of shares used in earnings per share computations:</b>                   |                                     |             |
| Weighted-average outstanding common shares  | 81,322                              | 84,730      |
| Weighted average common equivalent shares - dilutive effect of stock options and awards | 1,706                               | 1,694       |
| Shares used in diluted earnings per share computations                                  | 83,028                              | 86,424      |

For the purpose of calculating the shares used in the diluted EPS calculation for the three months ending March 31, 2006, 1,708,000 anti-dilutive market price options have been excluded from the EPS calculation. In addition, 35,000 performance stock units have been excluded from the calculation of diluted EPS because the number of shares ultimately issued is contingent on our performance against goals established for the performance period.

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For the purpose of calculating the shares used in the diluted EPS calculation for the three months ending March 31, 2005, there were no anti-dilutive options outstanding. There were no performance stock units awarded prior to 2006.

**Note E Business Segments**

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

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

| <b>In thousands</b>              | <b>Three Months Ended March 31,</b> |             |
|----------------------------------|-------------------------------------|-------------|
|                                  | <b>2006</b>                         | <b>2005</b> |
| Operating revenues               |                                     |             |
| Direct Marketing                 | \$ 164,318                          | \$ 170,019  |
| Shoppers                         | 114,077                             | 98,274      |
| Total operating revenues         | \$ 278,395                          | \$ 268,293  |
| Operating Income                 |                                     |             |
| Direct Marketing                 | \$ 20,384                           | \$ 24,520   |
| Shoppers                         | 21,926                              | 20,868      |
| Corporate Activities             | (2,740)                             | (3,069)     |
| Total operating income           | \$ 39,570                           | \$ 42,319   |
| Income before income taxes       |                                     |             |
| Operating income                 | \$ 39,570                           | \$ 42,319   |
| Interest expense                 | (855)                               | (203)       |
| Interest income                  | 26                                  | 78          |
| Other, net                       | (264)                               | (489)       |
| Total income before income taxes | \$ 38,477                           | \$ 41,705   |

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

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.

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.

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Net pension cost for both plans included the following components:

| <b>In thousands, except per share amounts</b> | <b>Three Months Ended March 31,</b> |               |
|---|-------------------------------------|---------------|
|   | <b>2006</b>                         | <b>2005</b>   |
| Service Cost                                  | \$ 198                              | \$ 154        |
| Interest Cost                                 | 1,815                               | 1,669         |
| Expected return on plan assets                | (2,002)                             | (1,981)       |
| Amortization of prior service cost            | 15                                  | 15            |
| Transition obligation                         | 24                                  | 24            |
| Recognized actuarial loss                     | 710                                 | 447           |
| <b>Net periodic benefit cost</b>              | <b>\$ 760</b>                       | <b>\$ 328</b> |

We are not required to make and do not intend to make a contribution to either pension plan in 2006 other than to the extent needed to cover benefit payments related to the unfunded plan.

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

This Quarterly Report on Form 10-Q 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 Section 27A of the Securities Exchange Act of 1933 and Section 21E of the Securities Exchange Act of 1934, each as amended. These forward looking statements are based on current information and expectations and are subject to risks and uncertainties that could cause our actual results to differ materially from those in the forward looking statements. These risk factors and a description of some of the risks and uncertainties potentially impacting our business and future performance can be found in our filings with the Securities and Exchange Commission, including our Form 10-K for the year ended December 31, 2005.

**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.

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 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; and

Execute the programs.

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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 with services and software products tailored to each industry or market. 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 thirty facilities worldwide, more than ten of which are located outside of the United States. Each of these centers possesses some specialization and are linked together to support the needs of our clients. We believe that we have the ability to provide services to new industries and markets by modifying our services and applications as opportunities are presented. Revenues from the Direct Marketing segment represented approximately 59% of our total revenue for the three months ended March 31, 2006.

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 March 31, 2006, our shoppers are zoned into 1,076 separate editions with total circulation in excess of 12.8 million in California and Florida each week (including 240,000 in South Orange County, California where Shoppers publish two editions each week). We plan to cover an additional circulation of at least 500,000 over the next several years in Northern California, Southern California, South Florida and the Tampa, Florida area. We believe that expansions provide increased revenues and, ultimately, increased operating income as the publications in these new areas mature. Revenues from the Shoppers segment represented approximately 41% of our total revenue for the three months ended March 31, 2006.

We derive 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. Our shoppers operate in local markets and are largely affected by the strength of the local economies.

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.

**Table of Contents****Results of Operations**

Operating results were as follows:

| <b>In thousands</b>        | <b>Three months ended</b> |                  | <b>Change</b> |
|----------------------------|---------------------------|------------------|---------------|
|                            | <b>March 31,</b>          | <b>March 31,</b> |               |
|                            | <b>2006</b>               | <b>2005</b>      |               |
| Revenues                   | \$ 278,395                | \$ 268,293       | 3.8%          |
| Operating expenses         | 238,825                   | 225,974          | 5.7%          |
| <b>Operating income</b>    | <b>\$ 39,570</b>          | <b>\$ 42,319</b> | <b>-6.5%</b>  |
| Net income                 | \$ 23,783                 | \$ 25,073        | -5.1%         |
| Diluted earnings per share | \$ 0.29                   | \$ 0.29          | 0.0%          |

*Revenues*

Consolidated revenues increased 3.8% to \$278.4 million while operating income decreased 6.5% to \$39.6 million in the first quarter of 2006 when compared to the first quarter of 2005. Our overall results reflect a double-digit revenue increase from the Shoppers segment, partially offset by a low single-digit revenue decline from the the Direct Marketing segment. Shoppers results were positively impacted by the acquisition of *The Flyer*, located in Tampa, Florida in April 2005, which contributed a little less than two-thirds of the revenue growth for the year. Shoppers results also reflect improved sales in established markets, new products and new year-over-year geographic expansions and household growth in California and Florida. Direct Marketing results reflect year-over-year revenue growth in three of Direct Marketing's five vertical markets. These results were affected by a large, complex, world-wide project that was launched and substantially completed in the first quarter of 2005 for a client in the high-tech vertical market. Excluding revenues from this project, first quarter 2006 Direct Marketing revenues would have been up in the low single-digits compared to the first quarter of 2005.

*Operating Expenses*

Overall operating expenses increased 5.7%, to \$238.8 million, in the first quarter of 2006 compared to the first quarter of 2005. The increase in consolidated operating expenses was a result of increased operating expenses from the Shoppers segment, partially offset by a decline in operating expenses from the Direct Marketing segment as well as a decrease in general corporate expense. The primary drivers of the increase in operating expenses were the acquisition of *The Tampa Flyer* in April 2005, higher postage costs due to the postal rate increase in January 2006, higher logistics-related transportation costs, stock-based compensation recorded in the first quarter of 2006 as a result of our adoption of SFAS No. 123R, and higher paper costs due to higher newsprint rates.

*Net Income/Earning Per Share*

Net income decreased 5.1%, to \$23.8 million, and diluted earnings per share were flat, at \$0.29 per share, in the first quarter of 2006 when compared to the first quarter of 2005. The decrease in net income was a result of decreased operating income and higher interest expense, partially offset by a lower tax rate in the first quarter of 2006 when compared to 2005. In 2006 we began expensing stock options and other equity-compensation, which impacted first quarter 2006 diluted earnings per share by approximately \$0.01 per share.

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

Direct Marketing operating results were as follows:

| <b>In thousands</b>     | <b>Three months ended</b> |                  |               |
|-------------------------|---------------------------|------------------|---------------|
|                         | <b>March 31,</b>          | <b>March 31,</b> |               |
|                         | <b>2006</b>               | <b>2005</b>      | <b>Change</b> |
| Revenues                | \$ 164,318                | \$ 170,019       | -3.4%         |
| Operating expenses      | 143,934                   | 145,499          | -1.1%         |
| <b>Operating income</b> | <b>\$ 20,384</b>          | <b>\$ 24,520</b> | <b>-16.9%</b> |

*Revenues*

Direct Marketing revenues decreased \$5.7 million, or 3.4%, in the first quarter of 2006 compared to the first quarter of 2005. These results reflect year-over-year revenue growth in three of Direct Marketing's five vertical markets. These results were affected by a large, complex, world-wide project that was launched and substantially completed in the first quarter of 2005 for a client in the high-tech vertical market. Excluding revenues from this project in the first quarter of 2005, first quarter 2006 revenues would have been up in the low single-digits compared to the first quarter of 2005. Our pharmaceutical/healthcare vertical produced revenue growth in excess of 20% and our select vertical also had growth in excess of 10% compared to the first quarter of 2005. Our retail vertical revenue growth was up in the low single-digits, while financial vertical revenue growth was down low double-digits compared to the first quarter of 2005. Revenue from our high tech vertical, which benefited from the one-time project in the first quarter of 2005, was down over 20% compared to the first quarter of 2005. Absent this one-time project in the first quarter of 2005, revenues from the high-tech vertical would have been down in the low double-digits. Revenues from our vertical markets are impacted by 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. In general, revenues for Direct Marketing are affected by general national and international economic trends.

From a service offering perspective, Direct Marketing experienced increased revenues from data processing, logistics and software sales. Partially offsetting these increases were declines in revenues from telesales, programming and account management.

Future revenues will depend on how successful we are at growing business with existing clients, acquiring new clients and meeting client demands, and the strength of the national and international economy. We believe that we will continue to 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.

*Operating Expenses*

Operating expenses decreased \$1.6 million, or 1.1%, in the first quarter of 2006 compared to the first quarter of 2005 as decreased labor costs, general and administrative expenses and depreciation and amortization expense were partially offset by stock-based compensation and increased production costs. Labor costs decreased \$1.3 million, or 1.8%, in the first quarter of 2006 compared to 2005 as a result of lower incentive compensation and lower payroll costs due to decreased headcount. This decrease was partially offset by stock-based compensation of \$1.2 million recorded in the first quarter of 2006 as a result of our adoption of SFAS No. 123R. Excluding stock-based compensation expense, labor costs were down \$2.5 million or 3.4% compared to the prior year quarter. Production and distribution costs increased \$0.9 million, or 1.6%, due to higher logistics-related transportation costs. General and administrative expense was down \$0.9 million or 7.3%, due to decreased bad debt and insurance expense. Depreciation and amortization expense decreased \$0.2 million, or 3.4%, due to assets becoming fully depreciated.

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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. Fuel costs increased significantly in 2005 and are expected to remain at high levels for the foreseeable future. These fuel costs are expected to continue to impact Direct Marketing's total production costs and total operating expenses.

**Shoppers**

Shoppers operating results were as follows:

| <b>In thousands</b>     | <b>Three months ended</b> |                  |               |
|-------------------------|---------------------------|------------------|---------------|
|                         | <b>March 31,</b>          | <b>March 31,</b> |               |
|                         | <b>2006</b>               | <b>2005</b>      | <b>Change</b> |
| Revenues                | \$ 114,077                | \$ 98,274        | 16.1%         |
| Operating expenses      | 92,151                    | 77,406           | 19.0%         |
| <b>Operating income</b> | <b>\$ 21,926</b>          | <b>\$ 20,868</b> | <b>5.1%</b>   |

*Revenues*

Shoppers revenues increased \$15.8 million, or 16.1%, in the first quarter of 2006 compared to the first quarter of 2005. The acquisition of The Tampa Flyer in April 2005 contributed a little less than two-thirds of this revenue growth. The remaining revenue increases primarily were the result of improved sales in established markets, new products and year-over-year geographic expansions and household growth in California and Florida. Total Shoppers circulation increased by 300,000 during the first quarter of 2006, including expansion of 220,000 in Northern California and 60,000 in the Tampa, Florida area. At the end of the quarter Shopper circulation reached over 12.8 million in California and Florida each week (including 240,000 in South Orange County, California where Shoppers publish two editions each week). We believe that expansions provide increased revenue opportunities, and plan to cover an additional circulation of at least 500,000 over the next several years in Northern California, Southern California, South Florida and the Tampa, Florida area. 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 from run-of-press (ROP, or in-book) advertising, primarily employment-related advertising and core sales. Revenues from distribution products were up slightly compared to the prior year quarter.

*Operating Expenses*

Operating expenses increased \$14.7 million, or 19.0%, in the first quarter of 2006 compared to the first quarter of 2005 as a result of increased labor costs, production and distribution costs, depreciation and amortization expense, stock-based compensation and the acquisition of The Tampa Flyer in April 2005. Total labor costs increased \$5.3 million, or 18.4%. Excluding the Tampa acquisition, labor costs increased \$1.8 million or 6.4%. \$0.4 million of this increase relates to stock-based compensation recorded in the first quarter of 2006 as a result of our adoption of SFAS No. 123R. The remaining increase in labor costs relates to higher payroll costs to support higher circulation volumes and expansions, and higher pension costs. Total production costs increased \$7.4 million, or 18.3%. Excluding the Tampa acquisition, production costs increased \$3.1 million or 7.7%, including increased postage costs, increased offload printing expense due to increased print-and-deliver volumes and higher printing rates, and higher paper costs due to increased newsprint prices. Excluding the Tampa acquisition, postage expense was up \$2.2 million or 9.7% due to the postal rate increase in January 2006 and circulation growth. The increase in production costs was partially offset by lower repairs and maintenance expense. Total general and administrative costs increased \$1.5 million, or 21.8%. Excluding the Tampa



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acquisition, general and administrative costs increased \$0.8 million or 11.8%, primarily due to higher promotion costs and higher general business expenses, partially offset by decreased legal expense and insurance expense. Total depreciation expense was up \$0.3 million or 17.7%, with the majority of the increase attributable to the Tampa acquisition. Intangible amortization related to the Tampa acquisition was \$0.3 million during the first quarter of 2006.

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 January of 2006, and likely will increase again in the future. Increased postage rates increased Shoppers' total production costs in the first quarter of 2006 and will increase production costs for the remainder of the year. Newsprint prices, which have been increasing since 2004, continued to increase in the first quarter of 2006 and are expected to continue to increase throughout the remainder of the year. This increase resulted in higher production costs in the first quarter of 2006, and rising newsprint prices are expected to affect Shoppers' production costs for the remainder of the year.

## **General Corporate Expense**

General corporate expense decreased \$0.3 million, or 10.7%, during the first quarter of 2006 compared to the first quarter of 2005, due to decreased labor, primarily due to lower incentive compensation, and decreased insurance expense. Partially offsetting this decrease was \$0.1 million of stock-based compensation recorded in the first quarter of 2006 as a result of our adoption of SFAS No. 123R.

## **Interest Expense**

Interest expense was up \$0.7 million in the first quarter of 2006 compared to first quarter of 2005. This increase is due to higher outstanding debt levels, primarily due to the acquisition of The Tampa Flyer in April 2005 and repurchases of our common stock, and higher interest rates under our revolving credit facility in the first quarter of 2006 than in the first quarter of 2005.

## **Interest Income**

Interest income was down slightly in the first quarter of 2006 compared to the first quarter of 2005 due to lower cash levels.

## **Other Income and Expense**

Other net expense for the first quarter of 2006 primarily consists of stockholder expenses and balance-based bank charges.

## **Income Taxes**

Income tax expense decreased \$1.9 million in the first quarter of 2006 compared to the first quarter of 2005. This decrease was due to lower pre-tax income in the first quarter of 2006. The effective tax rate was 38.2% for the first quarter of 2006, down from 39.9% for the first quarter of 2005.

## **Liquidity and Capital Resources**

### *Sources and Uses of Cash*

As of March 31, 2006, cash and cash equivalents were \$17.4 million, decreasing \$7.2 million from cash and cash

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equivalents at December 31, 2005. This net decrease was a result of net cash used in financing activities of \$31.6 million and net cash used in investing activities of \$10.4 million, partially offset by cash provided by operating activities of \$34.8 million.

### *Operating Activities*

Net cash provided by operating activities for the three months ended March 31, 2006 was \$34.8 million, compared to \$38.0 million for the first three months of 2005. The \$3.2 million year-over-year decrease was attributable to changes within working capital assets and liabilities and the \$1.3 million decrease in net income.

For the three months ended March 31, 2006 our principal working capital requirements, which directly affected net cash provided by operating activities, were as follows:

A decrease in accounts receivable attributable to lower revenues and a higher beginning year accounts receivable balance. Days sales outstanding of approximately 56 days remained unchanged from December 31, 2005 and was down from 58 days at March 31, 2005;

An increase in inventory due to increased paper prices and timing of purchases;

An increase in prepaid expenses and other current assets due to timing of payments;

A decrease in accounts payable attributable to lower operating expenses and timing of vendor payments;

A decrease in accrued payroll and related expenses due to payment of 2005 bonuses; and

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

### *Investing Activities*

Net cash outflows from investing activities were \$10.4 million for the first three months of 2006, compared to \$10.2 million for the first three months of 2005. The difference between net cash outflows from investing activities in 2006 and 2005 is primarily the result of the increased capital expenditures in the first quarter of 2006 to support growth.

### *Financing Activities*

Net cash outflows from financing activities were \$31.6 million for the three months ended March 31, 2006 compared to \$28.3 million for the three months ended March 31, 2005. The difference between net cash outflows from financing activities in 2006 and 2005 is attributable primarily to \$5.8 million more spent on repurchases of our common stock and \$2.0 million higher net repayment of borrowings in the first three months of 2006 compared to the first three months of 2005. Partially offsetting the difference in cash outflows from financing activities in 2006 compared to 2005 were \$3.1 million higher proceeds received from the exercise of stock options in the first quarter of 2006 compared to the first quarter of 2005.

We consider such factors as current assets, current liabilities, total debt, revenues, operating income, 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. The management of cash is carefully controlled both 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 facility. On August 12, 2005, Harte-Hanks entered into a five-year \$125 million revolving credit facility (the Credit Facility ) with JPMorgan Chase Bank, N.A., as administrative agent. The Credit Facility allows us to obtain revolving credit loans and provides for the issuance of letters of credit. For each borrowing under the Credit Facility,

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we can generally choose to have the interest rate for that borrowing calculated based on either JPMorgan Chase Bank's

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publicly announced New York prime rate or on a Eurodollar (as defined in the Five-Year Credit Agreement) rate plus a spread. The spread is determined based on our total debt-to-EBITDA (as defined in the Five-Year Credit Agreement) ratio then in effect, and ranges from .315% to .6%. There is a facility fee that we are also required to pay under the Credit Facility that is based on a rate applied to the total commitment amount under the Credit Facility, regardless of how much of that commitment we have actually drawn upon. The facility fee rate ranges from .085% to .15%, depending on our total debt-to-EBITDA ratio then in effect. In addition, we will also be charged a letter of credit fee with respect to any outstanding letters of credit issued under this credit facility. That fee is calculated by applying a rate equal to the spread applicable to Eurodollar based loans plus a fronting fee of .125% per annum to the average daily undrawn amount of the outstanding letters of credit.

Under the Credit Facility, we are required to maintain an interest coverage ratio of not less than 2.75 to 1 and a total debt-to-EBITDA ratio of not more than 3.0 to 1. The Credit Facility also contains covenants restricting our and our subsidiaries' ability to grant liens and enter into certain transactions and limits the total amount of indebtedness of our subsidiaries to \$20 million.

The Credit Facility also includes customary covenants regarding reporting obligations, delivery of notices regarding certain events, maintaining our corporate existence, payment of obligations, maintenance of our properties and insurance thereon at customary levels with financially sound and reputable insurance companies, maintaining books and records and compliance with applicable laws. The Credit Facility provides for customary events of default including nonpayment of principal or interest, breach of representations and warranties, violations of covenants, failure to pay certain other indebtedness, bankruptcy and material judgments and liabilities, certain violations of environmental laws or ERISA or the occurrence of a change of control. As of March 31, 2006, we were in compliance with all of the covenants of our credit facility.

The amount of cash on hand and borrowings available under the credit facility are influenced by a number of factors, including fluctuations in our operating results, revenue growth, accounts receivable collections, capital expenditures, tax payments, share repurchase, acquisitions and dividends.

We believe that our 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 March 31, 2006, we had \$75.0 million of unused borrowing capacity under our credit 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

Stock-based compensation.

Other than the adoption of SFAS No. 123R in January 2006 described in Note C of the Notes to Unaudited Condensed Consolidated Financial Statements, there have been no changes to the critical accounting policies described in our annual report on form 10-K for the year ended December 31, 2005.



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Beginning January 1, 2006 we account for stock-based compensation in accordance with SFAS No. 123R. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the requisite service period. Determining the fair value of share-based awards requires judgment, including in some cases estimating expected term, volatility and dividend yield. In addition, judgment is required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

**Recent Accounting Pronouncements**

Effective January 1, 2006, we adopted SFAS No. 123R under the modified-prospective transition method. SFAS No. 123R requires that all stock-based awards be recognized as operating expense, based on their fair values on the date of grant, over the requisite service period, in the consolidated statement of operations. Prior to January 1, 2006, we accounted for stock-based awards under the recognition and measurement principles of APB No. 25 and related interpretations. Accordingly, prior to January 1, 2006 no compensation expense was recognized for stock-based awards granted where the exercise price was equal to the market price of the underlying stock on the date of grant. We recorded incremental expense for stock-based compensation, as a result of the adoptions of SFAS No. 123R, of \$1,751,000 (\$1,082,000, net of tax) for the quarter ended March 31, 2006. The adoption of SFAS No. 123R did not have a significant impact on our financial position. Prior to our adoption of SFAS No. 123R, benefits of tax deductions in excess of recognized compensation costs were reported as operating cash flows. SFAS No. 123R requires excess tax benefits be reported as both a financing cash inflow and an operating cash outflow rather than as a reduction of taxes paid.

In November 2005, the Financial Accounting Standards Board (FASB) issued Staff Position (FSP) SFAS No. 123R-3, Transition Election to Accounting for the Tax Effects of Share Based Payment Awards. This FSP requires an entity to follow either the transition guidance for the additional paid-in capital pool as described in SFAS No. 123R, or the alternative transition method as described in this FSP. An entity that adopts SFAS No. 123R using the modified prospective application may make a one-time election to adopt the transition method described in this FSP. We have elected to adopt the transition method described in this FSP.

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

Our earnings are affected by changes in short-term interest rates as a result of our revolving credit agreement, which bears interest at variable rates based on Eurodollar rates (effective rate of 5.09% at March 31, 2006) and has a maturity date of August 12, 2010. At March 31, 2006, our debt balance was \$50 million. Our earnings are also affected by changes in short-term interest rates as a result of a deferred compensation agreement, which bears interest at variable rates based on Prime (effective rate of 7.75% at March 31, 2006) and has a balance of \$6.5 million at March 31, 2006. Assuming the actual level of borrowing and deferred compensation balance throughout the first quarter of 2006 and assuming a one percentage point change in the quarter's average interest rates, it is estimated that our net income for the three months ended March 31, 2006 would have changed by approximately \$97,000. Due to our debt level and deferred compensation balance at March 31, 2006, 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 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. Due to the level of operations in foreign countries, the impact of fluctuations in foreign exchange rates is not significant to our overall earnings.

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### **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). 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 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 first quarter of 2006 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.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

From time to time we become involved in various 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 are not expected to have a material effect on our financial condition or operations.

### **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 Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on 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.

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

The following table contains information about our purchases of equity securities during the first quarter of 2006:

| Period                 | Total<br>Number of<br>Shares | Average<br>Price<br>Paid per<br>Share | Total Number   | Maximum   |
|------------------------|------------------------------|---------------------------------------|--|---|
|                        |                              |                                       | Purchased<br>as Part of<br>a Publicly<br>Announced Plan(1) | Number of<br>Shares that<br>May Yet Be<br>Purchased Under<br>the Plan |
| January 1 31, 2006     | 178,583                      | \$ 26.71                              | 93,200   | 6,261,928   |
| February 1 28, 2006(2) | 583,900                      | \$ 28.60                              | 583,900  | 5,678,028   |
| March 1 31, 2006       | 147,188                      | \$ 27.26                              | 138,400  | 5,539,628   |
| Total                  | 909,671                      | \$ 28.01                              | 815,500  |   |

- (1) During the first quarter of 2006, 815,500 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 49,900,000 shares of our outstanding common stock. As of March 31, 2006 we had repurchased a total of 44,360,372 shares at an average price of \$17.59 per share under this program.
- (2) On February 21, 2006 we purchased 300,000 shares of our common stock for \$28.39 per share (\$0.20 below the closing price per share of our common stock on February 21, 2006) from Mr. Houston H. Harte. Mr. Harte is a member of our Board of Directors.

**Item 6. Exhibits**

See Index to Exhibits on Page 26.



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

|                      |   |
|----------------------|---|
|                      | HARTE-HANKS, INC.   |
| May 10, 2006<br>Date | /s/ Richard M. Hochhauser<br>Richard M. Hochhauser<br>President and Chief Executive Officer       |
| May 10, 2006<br>Date | /s/ Dean H. Blythe<br>Dean H. Blythe<br>Senior Vice President and<br>Chief Financial Officer      |
| May 10, 2006<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 | 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 | 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 herewith