HARTE HANKS INC
Form 10-Q
November 06, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

or

o **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 001-7120

HARTE-HANKS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**74-1677284**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

9601 McAllister Freeway, Suite 610, San Antonio, Texas 78216

(Address of principal executive offices) (Zip Code)

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

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definitions of large accelerated filer, accelerated filer and small reporting company in Rule 12b-2 of the Exchange Act

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares outstanding of each of the registrant s classes of common stock as of October 15, 2012 was 62,773,058 shares of common stock, all of one class.

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HARTE-HANKS, INC. AND SUBSIDIARIES

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FORM 10-Q REPORT

September 30, 2012

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Item 1. Interim Condensed Consolidated Financial Statements

Harte-Hanks, Inc. and Subsidiaries

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

	September 30, 2012 (Unaudited)	December 31, 2011 (Audited)
Assets		
Current assets		
Cash and cash equivalents	$ 35,815	$ 86,778
Accounts receivable *(less allowance for doubtful accounts of $3,046 at September 30, 2012 and $3,346 at December 31, 2011)*	140,089	156,396
Inventory	6,140	7,110
Prepaid expenses	8,701	8,955
Current deferred income tax asset	7,652	9,590
Other current assets	7,119	6,688
Total current assets	205,516	275,517
Property, plant and equipment *(less accumulated depreciation of $235,106 at September 30, 2012 and $231,221 at December 31, 2011)*	63,535	71,583
Goodwill	408,715	565,651
Other intangible assets *(less accumulated amortization of $9,622 at September 30, 2012 and $15,741 at December 31, 2011)*	5,978	14,989
Other assets	4,789	4,774
Total assets	$ 688,533	$ 932,514
Liabilities and Stockholders Equity		
Current liabilities		
Current maturities of long-term debt	$ 12,250	$ 69,188
Accounts payable	38,679	46,373
Accrued payroll and related expenses	15,596	22,227
Deferred revenue and customer advances	33,758	36,731
Income taxes payable	1,210	4,594
Customer postage deposits	14,121	15,759
Other current liabilities	10,219	10,197
Total current liabilities	125,833	205,069
Long-term debt	101,063	110,250
Other long-term liabilities *(including deferred income taxes of $51,105 at September 30, 2012 and $92,448 at December 31, 2011)*	122,798	170,840
Total liabilities	349,694	486,159
Stockholders equity		
Common stock, $1 par value per share, 250,000,000 shares authorized. 118,718,351 shares issued at September 30, 2012 and 118,487,455 shares issued at December 31, 2011	118,718	118,487
Additional paid-in capital	342,054	341,149
Retained earnings	1,165,999	1,276,266
Less treasury stock: 55,968,189 shares at cost at September 30, 2012 and 55,668,137 shares at cost at December 31, 2011	(1,246,153)	(1,244,224)
Accumulated other comprehensive loss	(41,779)	(45,323)
Total stockholders equity	338,839	446,355
Total liabilities and stockholders equity	$ 688,533	$ 932,514

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

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

(Unaudited)

	Three Months Ended September 30, 2012	2011
Operating revenues	$ 195,799	$ 212,788
Operating expenses		
Labor	82,509	88,214
Production and distribution	76,230	81,295
Advertising, selling, general and administrative	15,904	17,439
Depreciation and software amortization	4,740	4,957
Intangible asset amortization	204	168
Total operating expenses	179,587	192,073
Operating income	16,212	20,715
Other expenses (income)		
Interest expense	850	889
Interest income	(17)	(52)
Other, net	751	(540)
	1,584	297
Income before income taxes	14,628	20,418
Income tax expense	5,765	8,290
Net income	$ 8,863	$ 12,128
Basic earnings per common share	$ 0.14	$ 0.19
Weighted-average common shares outstanding	62,963	62,798
Diluted earnings per common share	$ 0.14	$ 0.19
Weighted-average common and common equivalent shares outstanding	63,205	63,059
Other comprehensive income (loss), net of tax		
Adjustment to pension liability	$ 900	$ 685
Foreign currency translation adjustments	871	(1,875)
Total other comprehensive income (loss), net of tax	1,771	(1,190)
Comprehensive income	$ 10,634	$ 10,938

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

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

(Unaudited)

	Nine Months Ended September 30, 2012		2011	
Operating revenues	$	590,108	$	626,141
Operating expenses				
Labor		257,364		268,497
Production and distribution		225,861		240,087
Advertising, selling, general and administrative		48,636		50,120
Impairment of goodwill and other intangible assets		165,336		0
Depreciation and software amortization		15,821		15,270
Intangible asset amortization		611		587
Total operating expenses		713,629		574,561
Operating income (loss)		(123,521)		51,580
Other expenses (income)				
Interest expense		2,749		2,151
Interest income		(76)		(188)
Other, net		1,809		575
		4,482		2,538
Income (loss) before income taxes		(128,003)		49,042
Income tax expense (benefit)		(33,954)		19,572
Net income (loss)	$	(94,049)	$	29,470
Basic earnings (loss) per common share	$	(1.49)	$	0.47
Weighted-average common shares outstanding		62,960		63,291
Diluted earnings (loss) per common share	$	(1.49)	$	0.46
Weighted-average common and common equivalent shares outstanding		62,960		63,669
Other comprehensive income (loss), net of tax				
Adjustment to pension liability	$	2,702	$	2,055
Foreign currency translation adjustments		842		(851)
Total other comprehensive income, net of tax		3,544		1,204
Comprehensive income (loss)	$	(90,505)	$	30,674

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)

	Nine Months Ended September 30, 2012	2011
Cash Flows from Operating Activities		
Net income (loss)	$ (94,049)	$ 29,470
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Impairment of goodwill and other intangible assets	165,336	0
Depreciation and software amortization	15,821	15,270
Intangible asset amortization	611	587
Stock-based compensation	2,767	3,810
Excess tax benefits from stock-based compensation	(57)	(214)
Net pension payments	(370)	(358)
Deferred income taxes	(43,385)	10,272
Other, net	27	123
Changes in operating assets and liabilities, net of acquisitions:		
Decrease in accounts receivable, net	16,307	3,374
Decrease in inventory	970	367
Increase in prepaid expenses and other current assets	(177)	(70)
Decrease in accounts payable	(7,694)	(13,258)
Decrease in other accrued expenses and other current liabilities	(16,025)	(15,312)
Other, net	887	(223)
Net cash provided by operating activities	40,969	33,838
Cash Flows from Investing Activities		
Purchases of property, plant and equipment	(8,488)	(16,444)
Proceeds from sale of property, plant and equipment	5	59
Net cash used in investing activities	(8,483)	(16,385)
Cash Flows from Financing Activities		
Repayment of borrowings	(66,125)	(8,032)
Debt refinancing costs	0	(782)
Issuance of common stock	637	697
Excess tax benefits from stock-based compensation	57	214
Purchase of treasury stock	(2,037)	(8,363)
Dividends paid	(16,218)	(15,312)
Net cash used in financing activities	(83,686)	(31,578)
Effect of exchange rate changes on cash and cash equivalents	237	(77)
Net decrease in cash and cash equivalents	(50,963)	(14,202)
Cash and cash equivalents at beginning of year	86,778	85,996
Cash and cash equivalents at end of period	$ 35,815	$ 71,794

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Harte-Hanks, Inc. and Subsidiaries

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

(2012 Unaudited)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at December 31, 2010	118,296	336,795	1,252,438	(1,236,024)	(33,682)	437,823
Exercise of stock options and release of nonvested shares	191	522	0	(193)	0	520
Net tax effect of options exercised and release of nonvested shares	0	(959)	0	0	0	(959)
Stock-based compensation	0	4,988	0	0	0	4,988
Dividends paid ($0.320 per share)	0	0	(20,370)	0	0	(20,370)
Treasury stock issued	0	(197)	0	356	0	159
Purchase of treasury stock	0	0	0	(8,363)	0	(8,363)
Net income	0	0	44,198	0	0	44,198
Other comprehensive loss	0	0	0	0	(11,641)	(11,641)
Balance at December 31, 2011	118,487	341,149	1,276,266	(1,244,224)	(45,323)	446,355
Exercise of stock options and release of nonvested shares	231	406	0	(179)	0	458
Net tax effect of options exercised and release of nonvested shares	0	(2,081)	0	0	0	(2,081)
Stock-based compensation	0	2,767	0	0	0	2,767
Dividends paid ($0.255 per share)	0	0	(16,218)	0	0	(16,218)
Treasury stock issued	0	(187)	0	287	0	100
Purchase of treasury stock	0	0	0	(2,037)	0	(2,037)
Net loss	0	0	(94,049)	0	0	(94,049)
Other comprehensive income	0	0	0	0	3,544	3,544
Balance at September 30, 2012	$ 118,718	$ 342,054	$ 1,165,999	$ (1,246,153)	$ (41,779)	$ 338,839

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

Consolidation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of Harte-Hanks, Inc. and its subsidiaries (the Company). All intercompany accounts and transactions have been eliminated in consolidation. Certain prior year amounts have been reclassified for comparative purposes.

In the Condensed Consolidated Balance Sheets, amounts related to postage advances from our Direct Marketing customers were previously included in the line item Other current liabilities . These postage advances are now being disclosed as a separate line item titled Customer postage deposits . Previously we had disclosed these postage advance amounts in our Notes to Unaudited Condensed Consolidated Financial Statements.

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.

Interim Financial Information

The financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) 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. GAAP 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 nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The information included in this Form 10-Q should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2011.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results and outcomes could differ from those estimates and assumptions. On an ongoing basis management reviews its estimates based on currently available information. Changes in facts and circumstances could result in revised estimates and assumptions.

Operating Expense Presentation in Consolidated Statements of Comprehensive Income

Labor in the Consolidated Statements of Comprehensive Income includes all employee payroll and benefits, including stock-based compensation, along with temporary labor costs. Production and distribution and Advertising, selling, general and administrative do not include labor, depreciation or amortization.

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Note B - Recent Accounting Pronouncements

In the first quarter of 2012, we adopted Accounting Standards Updates (ASU) 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. ASU 2011-05 eliminates the option to present other comprehensive income in the statement of changes in equity and provides the option to present the components of net income and comprehensive income in either one combined financial statement or two consecutive financial statements. We previously presented the components of comprehensive income in our Consolidated Statements of Stockholders Equity and Comprehensive Income (now titled Consolidated Statements of Changes in Equity). In connection with this adoption we have presented the components of net income and comprehensive income in one combined financial statement, the Consolidated Statements of Comprehensive Income. The adoption of ASU 2011-05 did not affect our operating results, cash flows or financial position.

In the third quarter of 2012, the Financial Accounting Standards Board (FASB) issued ASU No. 2012-02, *Intangibles Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment* (ASU 2012-12). ASU 2012-02 allows an entity to first assess qualitative factors to determine whether it is necessary to perform the quantitative impairment test for indefinite-lived intangible assets. An organization that elects to perform a qualitative assessment is required to perform the quantitative impairment test for an indefinite-lived intangible asset if it is more likely than not that the asset is impaired. We plan to adopt ASU 2012-02 in the first quarter of 2013. The adoption of ASU 2012-02 will not affect our operating results, cash flows or financial position.

Note C Long-Term Debt

Our long-term debt obligations were as follows:

In thousands		September 30, 2012		December 31, 2011
2008 Term Loan Facility, various interest rates based on LIBOR, due March 7, 2012	$	0	$	60,000
2010 Revolving Credit Facility, various interest rates based on LIBOR, due August 12, 2013 ($60.1 million capacity at September 30, 2012)		0		0
2011 Term Loan Facility, various interest rates based on LIBOR (effective rate of 2.22% at September 30, 2012), due August 16, 2016		113,313		119,438
Total debt		113,313		179,438
Less current maturities		12,250		69,188
Total long-term debt	$	101,063	$	110,250

The carrying values and estimated fair values of our outstanding debt were as follows:

	September 30, 2012				December 31, 2011			
In thousands		Carrying Value		Fair Value		Carrying Value		Fair Value
Total debt	$	113,313	$	113,313	$	179,438	$	179,286

The estimated fair values were calculated using current rates provided to us by our bankers for debt of the same remaining maturity and characteristics. These current rates are considered Level 2 inputs under the fair value hierarchy established by FASB ASC 820, *Fair Value Measurements and Disclosures*, (ASC 820).

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As of September 30, 2012, we were in compliance with all of the covenants of our credit facilities.

Note D - Income Taxes

Our third quarter 2012 income tax expense of $5.8 million resulted in an effective income tax rate of 39.4%. Our income tax benefit of $34.0 million in the first nine months of 2012 resulted in an effective income tax rate of 26.5%. Taxes in the first nine months of 2012 reflect a $165.3 million goodwill and other intangible assets impairment loss that resulted in a $48.7 million tax benefit. That tax benefit is entirely reflected as a reduction to our deferred income tax liabilities. The effective tax rate of this benefit of 29.4% was less than the federal statutory rate of 35%, primarily due to a portion of goodwill impairment that was not deductible, partially offset by the addition of state income taxes. Our effective income tax rate is derived by estimating pretax income and income tax expense for the year ending December 31, 2012.

Harte-Hanks, or one of our subsidiaries, files income tax returns in the U.S. federal, U.S. state and foreign jurisdictions. For U.S. state and foreign returns, we are no longer subject to tax examinations for tax years prior to 2007. For U.S. federal returns, we are no longer subject to tax examinations for tax years prior to 2008.

We have elected to classify any interest expense and penalties related to income taxes within income tax expense in our Consolidated Statements of Comprehensive Income. We had approximately $0.3 million of interest and penalties accrued at September 30, 2012. We did not have a significant amount of interest or penalties accrued at December 31, 2011.

Note E   Stock-Based Compensation

We recognized $0.6 million and $1.0 million of stock-based compensation during the three months ended September 30, 2012 and 2011, respectively. We recognized $2.8 million and $3.8 million of stock-based compensation during the nine months ended September 30, 2012 and 2011, respectively.

Our annual grant of stock-based awards occurred in the first quarter of 2012, consistent with the timing of previous annual grants. In the third quarter of 2012 we issued a total of 340,000 additional stock options, with an exercise price of $7.25 per share, to various officers of the company. All of these options were granted under the 2005 Omnibus Incentive Plan (2005 Plan). These options become exercisable in 25% increments on the first, second, third and fourth anniversaries of their date of grant, and expire on the tenth anniversary of their date of grant. The exercise price of these options is equal to the market value of the common stock on the date of grant. Market value is defined by the 2005 Plan as the closing price on the previous trading day.

The fair value of each option granted in the third quarter of 2012 was estimated on the date of grant at $2.17 using the Black-Scholes option-pricing model.

We did not have any other significant stock-based compensation activity in the third quarter of 2012.

Note F - Fair Value of Financial Instruments

ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 also establishes a fair value hierarchy that prioritizes the inputs used in valuation methodologies into three levels:

Level 1 Quoted prices in active markets for identical assets or liabilities.

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Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Because of their maturities and/or variable interest rates, certain financial instruments have fair values approximating their carrying values. These instruments include cash and cash equivalents, accounts receivable and trade payables. The fair value of our outstanding debt is disclosed in Note C, *Long-Term Debt.* As discussed in Note K, *Goodwill and Other Intangible Assets,* in the second quarter of 2012, the fair value of our Shoppers unit was calculated in relation to a step-one impairment analysis, and the fair value of Shoppers PP&E, goodwill and other intangible assets were calculated in relation to a step-two impairment analysis.

Note G - Earnings Per Share

Basic earnings per share is computed on the basis of the weighted average number of shares of 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 non-vested shares.

Reconciliations of basic and diluted earnings per share (EPS) are as follows:

	Three Months Ended September 30,	
In thousands, except per share amounts	**2012**	**2011**
BASIC EPS		
Net income	$ 8,863	$ 12,128
Weighted-average common shares outstanding used in earnings per share computations	62,963	62,798
Basic earnings per common share	$ 0.14	$ 0.19
DILUTED EPS		
Net income	$ 8,863	$ 12,128
Shares used in diluted earnings per share computations	63,205	63,059
Diluted earnings per common share	$ 0.14	$ 0.19
Computation of shares used in earnings per share computations:		
Weighted-average outstanding common shares	62,963	62,798

Weighted-average common equivalent shares - dilutive effect of stock options and awards	242	261
Shares used in diluted earnings per share computations	63,205	63,059

4.8 million and 5.4 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 September 30, 2012 and 2011, respectively. An insignificant number of anti-dilutive non-vested shares have been excluded from the calculation of shares used in

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the diluted EPS calculation for the three months ended September 30, 2012. 0.3 million anti-dilutive non-vested shares have been excluded from the calculation of shares used in the diluted EPS calculation for the three months ended September 30 2011.

In thousands, except per share amounts	**Nine Months Ended September 30,**			
		2012		**2011**
BASIC EPS				
Net income (loss)	$	(94,049)	$	29,470
Weighted-average common shares outstanding used in earnings per share computations		62,960		63,291
Basic earnings (loss) per common share	$	(1.49)	$	0.47
DILUTED EPS				
Net income (loss)	$	(94,049)	$	29,470
Shares used in diluted earnings per share computations		62,960		63,669
Diluted earnings (loss) per common share	$	(1.49)	$	0.46
Computation of shares used in earnings per share computations:				
Weighted-average outstanding common shares		62,960		63,291
Weighted-average common equivalent shares - dilutive effect of stock options and awards		0		378
Shares used in diluted earnings per share computations		62,960		63,669

There are no dilutive shares for the nine months ended September 30, 2012 as the Company has a net loss for the period. All 6.3 million outstanding market price options and 0.6 million outstanding non-vested shares have been excluded from the calculation of shares used in the diluted EPS calculation as they are considered anti-dilutive.

5.4 million anti-dilutive market price options and 0.3 million anti-dilutive non-vested shares have been excluded from the calculation of shares used in the diluted EPS calculation for the nine months ended September 30, 2011.

Note H Business Segments

Harte-Hanks is a worldwide, direct and targeted marketing company with operations in two segments Direct Marketing and Shoppers.

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Information about the operations of our two business segments follows:

In thousands	Three Months Ended September 30, 2012		Three Months Ended September 30, 2011	
Operating revenues				
Direct Marketing	$	140,993	$	151,974
Shoppers		54,806		60,814
Total operating revenues	$	195,799	$	212,788
Operating income				
Direct Marketing	$	18,720	$	20,514
Shoppers		614		3,085
Corporate Activities		(3,122)		(2,884)
Total operating income	$	16,212	$	20,715
Income before income taxes				
Operating income	$	16,212	$	20,715
Interest expense		(850)		(889)
Interest income		17		52
Other, net		(751)		540
Total income before income taxes	$	14,628	$	20,418

In thousands	Nine Months Ended September 30, 2012		Nine Months Ended September 30, 2011	
Operating revenues				
Direct Marketing	$	423,243	$	445,776
Shoppers		166,865		180,365
Total operating revenues	$	590,108	$	626,141
Operating income (loss)				
Direct Marketing	$	50,951	$	56,850
Shoppers		(165,131)		3,214
Corporate Activities		(9,341)		(8,484)
Total operating income (loss)	$	(123,521)	$	51,580
Income (loss) before income taxes				
Operating income (loss)	$	(123,521)	$	51,580
Interest expense		(2,749)		(2,151)
Interest income		76		188
Other, net		(1,809)		(575)
Total income (loss) before income taxes	$	(128,003)	$	49,042

Note I 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. We elected to freeze benefits under this defined benefit pension plan as of December 31, 1998.

In 1994, we adopted a non-qualified, unfunded, supplemental pension plan covering certain employees, which provides for incremental pension payments so that total pension payments equal those amounts that would have

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been payable from our principal pension plan if it were not for limitations imposed by income tax regulations. The benefits under this supplemental pension plan continue to accrue as if the principal pension plan had not been frozen.

Net pension cost for both plans included the following components:

In thousands	Three Months Ended September 30, 2012	2011
Service cost	$ 117	$ 114
Interest cost	1,960	2,030
Expected return on plan assets	(1,683)	(1,756)
Amortization of prior service cost	1	12
Recognized actuarial loss	1,500	1,130
Net periodic benefit cost	$ 1,895	$ 1,530

In thousands	Nine Months Ended September 30, 2012	2011
Service cost	$ 350	$ 343
Interest cost	5,881	6,089
Expected return on plan assets	(5,050)	(5,267)
Amortization of prior service cost	3	36
Recognized actuarial loss	4,500	3,389
Net periodic benefit cost	$ 5,684	$ 4,590

We made contributions to our funded, frozen pension plan of $2.7 million in the third quarter and $5.1 million in the first nine months of 2012. We plan to make contributions to this pension plan of $1.0 million in the fourth quarter of 2012. These contributions to our funded, frozen pension plan are being made in order to obtain the Pension Protection Act of 2006 full funding limit exemption.

We are not required to make and do not intend to make any contributions to our unfunded, supplemental pension plan in 2012 other than to the extent needed to cover benefit payments. We expect benefit payments under this supplemental pension plan to total $0.3 million in the fourth quarter of 2012.

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Note J 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:

In thousands	Three Months Ended September 30, 2012	2011
Net income	$ 8,863	$ 12,128
Other comprehensive income:		
Adjustment to pension liability	1,501	1,142
Tax expense	(601)	(457)
Adjustment to pension liability, net of tax	900	685
Foreign currency translation adjustment	871	(1,875)
Total other comprehensive income (loss)	1,771	(1,190)
Total comprehensive income	$ 10,634	$ 10,938

In thousands	Nine Months Ended September 30, 2012	2011
Net income (loss)	$ (94,049)	$ 29,470
Other comprehensive income (loss):		
Adjustment to pension liability	4,503	3,425
Tax expense	(1,801)	(1,370)
Adjustment to pension liability, net of tax	2,702	2,055
Foreign currency translation adjustment	842	(851)
Total other comprehensive income	3,544	1,204
Total comprehensive income (loss)	$ (90,505)	$ 30,674

Note K Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price of an acquisition over the fair values of the identifiable net assets acquired. Other intangible assets with definite and indefinite useful lives are recorded at fair value at the date of acquisition. The Company tests its goodwill and other intangible assets with indefinite useful lives for impairment as of November 30 of each year and as of an interim date should factors or indicators become apparent that would require an interim test. The company assesses the impairment of its goodwill by determining the fair value of each of its reporting units and comparing the fair value to the carrying value for each reporting unit. We have identified our reporting units as Direct Marketing and Shoppers.

During the second quarter of 2012, the poor economic conditions that the Company has experienced since the second half of 2007 in California and Florida continued. These conditions were initially created by weakness in the real estate and associated financing markets and have spread and persist across virtually all categories. Management sees little, if any, improvement in the California and Florida economies and the

Company expects to have further challenges before performance improves. In response, during the first half of 2012, the Company continued its efforts to reduce expenses in the Shoppers business, primarily through organizational restructuring

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and the discontinuation of a number of unprofitable digital initiatives, including SaverTime and mobile apps.

As a result of continuing revenue declines in Shoppers, and in conjunction with management s evaluation of the business, the Company determined that a triggering event had occurred and that an interim step-one impairment test of Shoppers goodwill was warranted in connection with the preparation of its second quarter 2012 financial statements. The fair value of the Shoppers unit was estimated using a discounted cash flow model and a cash flow multiple model, which were consistent with those used in our most recent annual impairment testing as of November 30, 2011. The fair value of our Shoppers unit was estimated to be less than its related carrying value, and management determined that the goodwill balance with respect to this reporting unit was impaired and step-two testing was deemed necessary.

Step-two of the goodwill test consists of performing a hypothetical purchase price allocation, under which the estimated fair value of the reporting unit is allocated to its tangible and intangible assets based on their estimated fair values, with any residual amount being assigned to goodwill. During the step-two analysis, book value was estimated to approximate fair value for all working capital items, as well as a number of insignificant assets and liabilities. Owned real estate and buildings were valued using the market approach and comparable property values. Other significant property, plant and equipment items were valued using the cost approach and trending models to estimate the cost of reproduction and then adjusting for the diminution of value from physical deterioration and obsolescence. Intangible assets related to trade names and customer relationships were identified and the fair value of these intangible assets was estimated using a relief-from-royalty model and discounted cash flow model, respectively.

The models used to value the total Shoppers unit in step-one and the identified intangible assets in step-two relied heavily on management s assumptions. These assumptions, which are significant to the calculated fair values, are considered Level 3 inputs under the fair value hierarchy established by FASB ASC 820 as they are unobservable. The assumptions in step-one include discount rate, revenue growth rates, tax rates and operating margins. In addition to these assumptions, step-two assumptions include customer attrition rates and royalty rates. The discount rate represents the expected return on capital of the Shoppers unit. The discount rate was determined using a target structure of 30% debt and 70% equity. We used the interest rate of a 30-year government security to determine the risk-free rate in our weighted average cost of capital calculation. Projected growth rates and terminal growth rates are primarily driven by management s best estimate of future performance, giving consideration to historical performance and existing and anticipated economic and competitive conditions. Attrition assumptions used to value customer relationships are based on recent historical experience and management s best estimate based on a review of historical financial information. Royalty rates used to value trade names are based on similar licensing agreements within our industry. Assumed tax rates represent management s best estimates of blended federal and state income tax rates. Operating margin assumptions are primarily driven by management s best estimate of future performance, giving consideration to historical performance and existing and anticipated economic and competitive conditions.

The impairment analysis indicated that $156.9 million of goodwill and $8.4 million of other intangibles, relating to trade names and client relationships associated with the Tampa Flyer acquisition in April 2005, were impaired. As a result, a total impairment charge of $165.3 million was recorded in the consolidated statements of comprehensive income in the second quarter of 2012. The Company had not previously recorded impairments of either goodwill or other intangible assets. Therefore the amount of impairments recorded in the second quarter of 2012 represents the cumulative amount of goodwill and other intangible asset impairment charges through September 30, 2012.

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The changes in the carrying amount of goodwill are as follows:

In thousands	Direct Marketing	Shoppers	Total
Balance at December 31, 2011	$ 398,164	$ 167,487	$ 565,651
Purchase consideration	0	0	0
Impairment	0	(156,936)	(156,936)
Balance at September 30, 2012	$ 398,164	$ 10,551	$ 408,715

The changes in the carrying amount of other intangibles are as follows:

In thousands	Direct Marketing	Shoppers	Total
Balance at December 31, 2011	$ 5,504	$ 9,485	$ 14,989
Purchase consideration	0	0	0
Amortization	(184)	(427)	(611)
Impairment	0	(8,400)	(8,400)
Balance at September 30, 2012	$ 5,320	$ 658	$ 5,978

The Company s next annual impairment test will be performed during the fourth quarter of 2012, at which time the Company will perform step-one testing on both the Shoppers and Direct Marketing reporting units. The Company continues to monitor potential triggering events, including changes in the business climate in which it operates, attrition of key personnel, the current volatility in the capital markets, the Company s market capitalization compared to its book value, the Company s recent operating performance, and the Company s financial projections. The occurrence of one or more triggering events could require additional impairment testing, which could result in additional impairment charges.

Note L Litigation Contingencies

On January 25, 2010, Harte-Hanks Shoppers, Inc. (Shoppers), a California corporation and a subsidiary of Harte-Hanks, Inc. (Harte-Hanks), reached an agreement in principle with Shoppers employee Frank Gattuso and former employee Ernest Sigala, individually and on behalf of a certified class, to settle and resolve a previously disclosed class action lawsuit filed in 2001 (*Frank Gattuso et al. v. Harte-Hanks Inc. et al.,* as further described below). During the fourth quarter of 2009 we accrued the full $7.0 million associated with this agreement. This agreement in principle was reduced to a class settlement agreement executed by the parties, and received final approval from the court on May 26, 2011. Pursuant to the settlement agreement, Shoppers paid $7.0 million to establish the class settlement fund in June of 2011. In return, each member of the class, including Gattuso and Sigala, released all claims against Shoppers and its affiliates that in any way arose from or related to the matters which were the subject of, or could have been the subject of, the claims alleged in the class action lawsuit. Based upon the claims received from the class members, we reduced the accrual by $0.8 million in the first quarter of 2011 and $0.5 million in the second quarter of 2011. Payments under the class settlement agreement from the class settlement fund concluded in August 2011, and at that time $1.3 million of unclaimed funds reverted back to Shoppers.

We are also currently subject to various other legal proceedings in the course of conducting our businesses and, from time to time, we may become involved in additional claims and lawsuits incidental to our businesses. In the opinion of management, after consultation with counsel, none of these matters is currently considered to be reasonably possible of resulting in 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 or future claims and lawsuits and any resolution of a claim or lawsuit within a particular fiscal quarter may adversely impact our results of operations for that quarter. We expense legal costs as incurred, and all recorded legal

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liabilities are adjusted as required as better information becomes available to us. The factors we consider when recording an accrual for contingencies include, among others: (i) the opinions and views of our legal counsel; (ii) our previous experience; and (iii) the decision of our management as to how we intend to respond to the complaints.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Note Regarding Forward-Looking Statements

This report, including this Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A), contains 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 initiatives, (2) adjustments to our cost structure and other actions designed to respond to market conditions and improve our performance, and the anticipated effectiveness and expenses associated with these actions, (3) our financial outlook for revenues, earnings per share, operating income, expense related to equity-based compensation, capital resources and other financial items, (4) expectations for our businesses and for the industries in which we operate, including with regard to the negative performance trends in our Shoppers business and the adverse impact of continuing economic uncertainty in the United States and other economies on the marketing expenditures and activities of our Direct Marketing clients and prospects, (5) competitive factors, (6) acquisition, disposition of assets and development plans, (7) our stock repurchase program, (8) expectations regarding legal proceedings and other contingent liabilities, and (9) 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 ended December 31, 2011 (2011 Form 10-K) and in the Cautionary Note Regarding Forward-Looking Statements in our third quarter 2012 earnings release issued on October 25, 2012. 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 2011 Form 10-K. Our 2011 Form 10-K contains a discussion of other matters not included herein, such as disclosures regarding critical accounting policies and estimates, and contractual obligations.

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Harte-Hanks is a worldwide direct and targeted marketing company that provides multichannel direct and digital 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.

Our Direct Marketing services offer a wide variety of integrated, multichannel, data-driven solutions for top brands around the globe. We help our clients gain insight into their customers behaviors from their data and use that insight to create innovative multichannel marketing programs to deliver a return on marketing investment. We believe our clients success is determined not only by how good their tools are, but how well we help them use the tools to gain insight and analyze their consumers. This results in a strong and enduring relationship between our clients and their customers. We offer a full complement of capabilities and resources to provide a broad range of marketing services and data management software, in media from direct mail to email, including:

- agency and digital services;
- database marketing solutions;
- data quality software and services with Trillium Software;
- direct mail and supply chain management;
- fulfillment and contact centers; and
- lead generation.

Revenues from the Direct Marketing segment represented approximately 72% of our total revenues for the three months and nine months ended September 30, 2012.

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 mail to households and businesses in a particular geographic area. Through print and digital offerings, Shoppers is a trusted local source for saving customers money and helping businesses grow. Shoppers offer advertisers a geographically 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. Our Shoppers segment also provides online advertising and other services through our websites, *PennySaverUSA.com*® and *TheFlyer.com*®, as well as business websites and search engine marketing. Our websites are online advertising portals, bringing buyers and sellers together through our online offerings, such as local classifieds, business listings, coupons, special offers and PowerSites. PowerSites are templated websites for our customers, optimized to help small and medium-sized business owners establish a web presence and improve their lead generation. At September 30, 2012, we were publishing approximately 6,700 PowerSites weekly.

At September 30, 2012, our Shoppers publications were zoned into approximately 950 separate editions with total circulation of approximately 11.2 million shopper packages in California and Florida each week. Our distribution products can be zoned even tighter, into approximately 2,400 subzones. Shoppers are delivered in five major markets covering the greater Los Angeles market, the greater San Diego market, Northern California, South Florida and the greater Tampa market.

Revenues from the Shoppers segment represented approximately 28% of our total revenues for the three months and nine months ended September 30, 2012.

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 and business conditions. Direct Marketing revenues are also affected by the economic fundamentals of each industry

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that we serve, various market factors, including the demand for services by our clients, and the financial condition of and budgets available to specific clients, among other factors. We remain committed to making the investments necessary to execute our multichannel strategy while also continuing to adjust our cost structure to reduce costs in the parts of the business that are not growing as fast. We believe these actions will improve our profitability in future periods.

Our Shoppers operate in regional markets in California and Florida and are greatly affected by the strength of the state and local economies. Revenues from our Shoppers business are largely dependent on local advertising expenditures in the areas of California and Florida in which we operate. During the first nine months of 2012, the poor economic conditions that we have experienced since the second half of 2007 in California and Florida continued. These conditions were initially created by weakness in the real estate and associated financing markets and have spread and persist across virtually all categories. As a result of management s evaluation of the Shoppers business, we recorded a $165.3 million impairment loss in the second quarter of 2012 related to Shoppers goodwill and other intangible assets. We see little, if any, improvement in the California and Florida economies and we expect to have further challenges before our performance improves. In response, during the first nine months of 2012, we continued our efforts to reduce expenses in the Shoppers business, primarily through organizational restructuring and the discontinuance of a number of unprofitable digital initiatives, including SaverTime and mobile apps. We continue to invest in online offerings, particularly our PowerSites, where we are seeing good revenue growth and are adding capabilities that provide value for our readers and advertisers, and in other profitable digital initiatives. We believe the steps we are taking to improve overall efficiency, combined with our continued investments in digital initiatives, will improve our Shoppers performance in the long term.

Our principal operating expense items are labor, postage and transportation.

Results of Operations

Operating results were as follows:

In thousands, except per share amounts	**Three months ended September 30, 2012**	**Three months ended September 30, 2011**	**Change**	**Nine months ended September 30, 2012**	**Nine months ended September 30, 2011**	**Change**
Revenues	$ 195,799	$ 212,788	-8.0%	$ 590,108	$ 626,141	-5.8%
Operating expenses	179,587	192,073	-6.5%	713,629	574,561	24.2%
Operating income (loss)	$ 16,212	$ 20,715	-21.7%	$ (123,521)	$ 51,580	-339.5%
Net income (loss)	$ 8,863	$ 12,128	-26.9%	$ (94,049)	$ 29,470	-419.1%
Diluted earnings (loss) per share	$ 0.14	$ 0.19	-26.3%	$ (1.49)	$ 0.46	-423.9%

3rd Quarter 2012 vs. 3rd Quarter 2011

Revenues

Consolidated revenues decreased 8.0%, to $195.8 million, due to decreased revenues of $11.0 million, or 7.2%, from our Direct Marketing segment and decreased revenues of $6.0 million, or 9.9%, from our Shoppers segment. Direct Marketing results reflect the impact of a large, long standing retail customer which changed its marketing strategy to emphasize broadcast at the expense of direct mail. Direct Marketing experienced decreased revenues from our pharmaceutical, high-tech, select and retail verticals, and increased revenues from our financial vertical compared to the prior year quarter. Shoppers revenue performance reflects the continued impact that the difficult economic environments in California and Florida are having on our Shoppers business. The decrease in revenues was the result of decreased sales in established markets, including declines in most revenue categories.

Operating Expenses

Overall operating expenses decreased 6.5%, to $179.6 million, in the third quarter of 2012 compared to the third

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quarter of 2011. This $12.5 million decrease in operating expenses was driven by decreased operating expenses in Direct Marketing of $9.2 million, or 7.0%, and decreased operating expenses of $3.5 million, or 6.1%, in Shoppers, partially offset by an increase in general corporate expense of $0.2 million, or 8.3%. The decrease at Direct Marketing was primarily due to reductions in temporary labor, incentive compensation and headcount, all as a result of revenue performance, decreased mail supply chain costs resulting from decreased volumes, and decreased outsourced costs resulting from decreased outsourced volumes. The decrease at Shoppers was due to lower payroll costs from lower ad sales and headcount reductions, decreases in newsprint and job paper expenses due to declines in volumes, decreased facility lease expense, decreased bad debt expense and lower credit card processing fees. The overall decrease at Shoppers was partially offset by an increase in postage costs resulting from the January 2012 postage rate increase, an increase in outsourced costs due to increased outsourced volumes, and an increase in offload printing costs due to an increase in heatset volumes.

Net Income/Earnings Per Share

Net income decreased 26.9%, to $8.9 million, and diluted earnings per share decreased 26.3%, to $0.14 per share, in the third quarter of 2012 when compared to the third quarter of 2011. The decrease in net income was a result of decreased operating income from both Direct Marketing and Shoppers and changes in net foreign currency transaction gains and losses.

First Nine Months 2012 vs. First Nine Months 2011

Revenues

Consolidated revenues decreased 5.8%, to $590.1 million, due to decreased revenues of $22.5 million, or 5.1%, from our Direct Marketing segment and decreased revenues of $13.5 million, or 7.5%, from our Shoppers segment. Direct Marketing results reflect the impact of a large, long standing retail customer which changed its marketing strategy to emphasize broadcast at the expense of direct mail. Direct Marketing experienced decreased revenues from all of our verticals, with the high-tech vertical representing the largest revenue decrease. Shoppers revenue performance reflects the continued impact that the difficult economic environments in California and Florida are having on our Shoppers business. The decrease in revenues was the result of decreased sales in established markets, including declines in most revenue categories.

Operating Expenses

Overall operating expenses were $713.6 million in the first nine months of 2012, compared to $574.6 million in the first nine months of 2011. This $139.1 million year over year increase was a result of the impairment charges of $165.3 million discussed above. Excluding this impairment loss, operating expenses decreased $26.3 million, or 4.6%, compared to the first nine months of 2011. This $26.3 million decrease in operating expenses was driven by decreased operating expenses in Direct Marketing of $16.6 million, or 4.3%, and decreased operating expenses of $10.5 million, or 5.9%, in Shoppers (excluding the impairment charge), partially offset by an increase in general corporate expense of $0.9 million, or 10.1%. The decrease at Direct Marketing was primarily due to decreased outsourced costs resulting from decreased outsourced volumes, decreased mail supply chain costs resulting from decreased volumes, and reductions in temporary labor, incentive compensation and headcount, all as a result of revenue performance. The decrease at Shoppers was due to decreased severance costs, decreased stock-based compensation, lower payroll costs due to lower ad sales and headcount reductions, a decrease in facility lease expense, and lower credit card processing fees. The overall decrease at Shoppers was partially offset by legal accrual reductions in the first half of 2011, an increase in postage costs due to the January 2012 postage rate increases, and the write-off of software related to various digital initiatives in the second quarter of 2012.

Net Income/Earnings Per Share

We recorded a net loss of $94.0 million, and diluted loss per share of $1.49, in the first nine months of 2012. Excluding the impairment loss, net income and diluted earnings per share for first nine months of 2012 would have been $22.6 million and $0.36, respectively. These results, excluding the impairment loss, compare to net income of $29.5 million, and diluted earnings per share of $0.46 in the first nine months of 2011. The decrease in net income, excluding the impairment loss, is primarily a result of decreased operating income from both Direct

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Marketing and Shoppers, changes in net foreign currency transaction gains and losses, and an increase in general corporate expense.

Direct Marketing

Direct Marketing operating results were as follows:

In thousands, except per share amounts	Three months ended September 30, 2012	Three months ended September 30, 2011	Change	Nine months ended September 30, 2012	Nine months ended September 30, 2011	Change
Revenues	$ 140,993	$ 151,974	-7.2%	$ 423,243	$ 445,776	-5.1%
Operating expenses	122,273	131,460	-7.0%	372,292	388,926	-4.3%
Operating income	$ 18,720	$ 20,514	-8.7%	$		