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HEALTHCARE SERVICES GROUP INC
Form 10-Q
July 25, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2006

OR

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 0-120152

HEALTHCARE SERVICES GROUP, INC.
(Exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of
incorporation or organization)

23-2018365
(IRS Employer Identification
number)

3220 Tillman Drive-Suite 300, Bensalem, Pennsylvania 19020
(Address of principal executive office) (Zip code)

Registrant's telephone number, including area code: 215-639-4274

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 Act of 1934 during
the preceding 12 months (or for such shorter period that the registrant was
required to file such returns), (2) has been subject to such filing requirements
for the past 90 days.

YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an
accelerated filer or a non-accelerated filer. See definition of "accelerated
filer" and "large accelerated filer" as defined in Rule 12b-2 of the Exchange
Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of
common stock, as of the latest practicable date. Common Stock, \$.01 Par Value:
27,291,000 shares outstanding as of July 21, 2006.

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Total of 38 Pages

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PART I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS

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| | (Unaudited) June 30, 2006 | December 31, 2005 |
|---|---------------------------------|----------------------|
| | ----- | ----- |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 92,318,000 | \$ 91,005,000 |
| Accounts and notes receivable, less allowance for doubtful accounts of \$2,720,000 in 2006 and \$2,275,000 in 2005 | 64,626,000 | 59,197,000 |
| Inventories and supplies | 12,048,000 | 11,729,000 |
| Deferred income taxes | 491,000 | 355,000 |
| Prepaid expenses and other | 3,864,000 | 3,330,000 |
| | ----- | ----- |
| Total current assets | 173,347,000 | 165,616,000 |
| PROPERTY AND EQUIPMENT: | | |
| Laundry and linen equipment installations | 1,926,000 | 2,416,000 |
| Housekeeping and office equipment | 15,437,000 | 15,141,000 |
| Autos and trucks | 80,000 | 79,000 |
| | ----- | ----- |
| | 17,443,000 | 17,636,000 |
| Less accumulated depreciation | 12,734,000 | 12,892,000 |
| | ----- | ----- |
| | 4,709,000 | 4,744,000 |
| COSTS IN EXCESS OF FAIR VALUE OF NET ASSETS ACQUIRED- Less accumulated amortization of \$1,743,000 in 2006 and 2005 | 1,612,000 | 1,612,000 |
| NOTES RECEIVABLE- long term portion, net of discount | 5,442,000 | 4,555,000 |
| DEFERRED COMPENSATION FUNDING | 6,239,000 | 5,626,000 |
| DEFERRED INCOME TAXES- long term portion | 6,731,000 | 6,181,000 |
| OTHER NONCURRENT ASSETS | 89,000 | 96,000 |
| | ----- | ----- |
| TOTAL ASSETS | \$198,169,000 | \$188,430,000 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 9,170,000 | \$ 8,760,000 |
| Accrued payroll, accrued and withheld payroll taxes | 6,706,000 | 7,792,000 |
| Other accrued expenses | 1,685,000 | 657,000 |
| Income taxes payable | 377,000 | 1,467,000 |
| Accrued insurance claims | 4,661,000 | 4,405,000 |
| | ----- | ----- |
| Total current liabilities | 22,599,000 | 23,081,000 |
| ACCRUED INSURANCE CLAIMS- long term portion | 10,876,000 | 10,277,000 |
| DEFERRED COMPENSATION LIABILITY | 7,866,000 | 6,909,000 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock, \$.01 par value: 67,500,000 shares authorized, 28,866,000 shares issued in 2006 and 28,677,000 in 2005 | 289,000 | 287,000 |
| Additional paid in capital | 51,182,000 | 48,603,000 |
| Retained earnings | 118,548,000 | 112,299,000 |
| Common stock in treasury, at cost, 1,579,000 shares in 2006 and 1,616,000 in 2005 | (13,191,000) | (13,026,000) |
| | ----- | ----- |
| Total stockholders' equity | 156,828,000 | 148,163,000 |
| | ----- | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$198,169,000 | \$188,430,000 |
| | ===== | ===== |

See accompanying notes.

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CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

| | FOR THE THREE MONTHS ENDED JUNE 30, | |
|---|--|---------------|
| | 2006 | 2005 |
| Revenues | \$122,840,000 | \$116,048,000 |
| Operating costs and expenses: | | |
| Costs of services provided | 105,843,000 | 101,385,000 |
| Selling, general and administrative | 8,123,000 | 8,109,000 |
| Other Income: | | |
| Investment and interest income | 973,000 | 839,000 |
| Income before income taxes | 9,847,000 | 7,393,000 |
| Income taxes | 3,644,000 | 2,809,000 |
| Net Income | \$ 6,203,000 | \$ 4,584,000 |
| Basic earnings per common share | \$ 0.23 | \$ 0.17 |
| Diluted earnings per common share | \$ 0.22 | \$ 0.16 |
| Cash dividends per common share | \$ 0.11 | \$ 0.07 |
| Basic weighted average number of common shares outstanding | 27,414,000 | 26,878,000 |
| Diluted weighted average number of common shares outstanding | 28,691,000 | 28,404,000 |

See accompanying notes.

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CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

| | FOR THE SIX MONTHS ENDED JUNE 30, | |
|-------------------------------------|--------------------------------------|---------------|
| | 2006 | 2005 |
| Revenues | \$241,758,000 | \$230,743,000 |
| Operating costs and expenses: | | |
| Costs of services provided | 208,025,000 | 201,155,000 |
| Selling, general and administrative | 17,014,000 | 16,538,000 |
| Other Income: | | |
| Investment and interest income | 2,320,000 | 1,219,000 |
| Income before income taxes | 19,039,000 | 14,269,000 |

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| | | |
|---|---------------|--------------|
| Income taxes | 7,045,000 | 5,422,000 |
| | ----- | ----- |
| Net Income | \$ 11,994,000 | \$ 8,847,000 |
| | ===== | ===== |
| Basic earnings per common share | \$ 0.44 | \$ 0.33 |
| | ===== | ===== |
| Diluted earnings per common share | \$ 0.42 | \$ 0.31 |
| | ===== | ===== |
| Cash dividends per common share | \$ 0.21 | \$ 0.13 |
| | ===== | ===== |
| Basic weighted average number of common shares outstanding | 27,367,000 | 26,750,000 |
| | ===== | ===== |
| Diluted weighted average number of common shares outstanding | 28,656,000 | 28,221,000 |
| | ===== | ===== |

See accompanying notes.

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CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | FOR THE SIX MONTHS ENDED JUNE 30, | |
|--|--------------------------------------|--------------|
| | 2006 | 2005 |
| | ----- | ----- |
| Cash flows from operating activities: | | |
| Net Income | \$11,994,000 | \$ 8,847,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 952,000 | 977,000 |
| Bad debt provision | 625,000 | 625,000 |
| Deferred income taxes benefits | (686,000) | (739,000) |
| Unrealized gain on deferred compensation fund investments | (364,000) | (208,000) |
| Changes in operating assets and liabilities: | | |
| Accounts and notes receivable | (6,054,000) | (4,358,000) |
| Prepaid income taxes | | (286,000) |
| Inventories and supplies | (319,000) | (359,000) |
| Notes receivable- long term portion | (887,000) | 1,704,000 |
| Deferred compensation funding | (248,000) | (567,000) |
| Accounts payable and other accrued expenses | 1,438,000 | 631,000 |
| Accrued payroll, accrued and withheld payroll taxes | (357,000) | (40,000) |
| Accrued insurance claims | 855,000 | 1,169,000 |
| Deferred compensation liability | 957,000 | 1,005,000 |
| Income taxes payable | (1,091,000) | (1,016,000) |
| Prepaid expenses and other assets | (528,000) | (762,000) |
| | ----- | ----- |
| Net cash provided by operating activities | 6,287,000 | 6,623,000 |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Disposals of fixed assets | 95,000 | 33,000 |
| Additions to property and equipment | (1,012,000) | (992,000) |

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| | | |
|--|--------------|--------------|
| Net cash used in investing activities | (917,000) | (959,000) |
| Cash flows from financing activities: | | |
| Treasury stock transactions in benefit plans | (79,000) | (147,000) |
| Dividends paid | (5,745,000) | (3,466,000) |
| Acquisition of treasury stock | (613,000) | -- |
| Reissuance of treasury stock pursuant to Dividend Reinvestment Plan | 20,000 | 15,000 |
| Proceeds from the exercise of stock options | 1,597,000 | 3,065,000 |
| Tax benefit of stock option transactions | 763,000 | 2,555,000 |
| Net cash provided by (used in) financing activities | (4,057,000) | 2,022,000 |
| Net increase in cash and cash equivalents | 1,313,000 | 7,686,000 |
| Cash and cash equivalents at beginning of the period | 91,005,000 | 74,847,000 |
| Cash and cash equivalents at end of the period | \$92,318,000 | \$82,533,000 |
| Supplementary Cash Flow Information: | | |
| Income taxes cash payments, net of refunds | \$ 8,057,000 | \$ 4,908,000 |
| Issuance of 64,000 shares of Common Stock in 2006 and 90,000 shares of Common Stock in 2005 pursuant to Employee Stock Plans | \$ 728,000 | \$ 643,000 |

See accompanying notes.

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Consolidated Statements of Stockholders' Equity
(Unaudited)

| | For the Six Months Ended June 30, 2006 | | | |
|--|--|------------|--------------------|---------------|
| | Common Stock | Additional | | Retained |
| | Shares | Amount | Paid-in Capital | Earnings |
| Balance, December 31, 2005 | 28,677,000 | \$287,000 | \$48,603,000 | \$112,299,000 |
| Net income for the period | | | | 11,994,000 |
| Exercise of stock options and other share-based compensation, net of 2,000 shares tendered for payment | 189,000 | 2,000 | 1,595,000 | |
| Tax benefit arising from stock option transactions | | | 763,000 | |
| Acquisition of treasury stock (34,000 shares) | | | | |
| Shares purchased and shares sold in employee Deferred Compensation Plan and other benefit plans (5,000 shares) | | | | |
| Shares issued pursuant | | | | |

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| | | | | |
|---|------------|-----------|--------------|---------------|
| to Employee Stock Plans (64,000 shares) | | 209,000 | | |
| Cash dividends - \$.21 per common share | | | | (5,745,000) |
| Shares issued pursuant to Dividend Reinvestment Plan (1,000 shares) | | 12,000 | | |
| Balance, June 30, 2006 | 28,866,000 | \$289,000 | \$51,182,000 | \$118,548,000 |
| | ===== | ===== | ===== | ===== |

See accompanying notes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

NOTE 1 - BASIS OF REPORTING

The accompanying financial statements are unaudited and do not include certain information and note disclosures required by accounting principles generally accepted in the United States for complete financial statements. However, in our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The balance sheet shown in this report as of December 31, 2005 has been derived from, and does not include, all the disclosures contained in the financial statements for the year ended December 31, 2005. The financial statements should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005. The results of operations for either the quarter or the six month period ended June 30, 2006 are not necessarily indicative of the results that may be expected for the full fiscal year.

Inventories and supplies include housekeeping, linen and laundry supplies, as well as food provisions. Inventories and supplies are stated at cost to approximate a first-in, first-out (FIFO) basis. Linen supplies are amortized over a 24 month period.

NOTE 2 - OTHER CONTINGENCIES

We have a \$25,000,000 bank line of credit on which we may draw to meet short-term liquidity requirements in excess of internally generated cash flow. Amounts drawn under the line of credit are payable upon demand. At June 30, 2006 and December 31, 2005, there were no borrowings under the line of credit. However, we had outstanding at such dates \$23,925,000 and \$17,925,000, respectively, of irrevocable standby letters of credit which relate to payment obligations under our insurance programs. As a result of the letters of credit issued, the amount available under the line of credit was reduced by \$23,925,000 and \$17,925,000 at June 30, 2006 and December 31, 2005, respectively. The line of credit requires us to satisfy two financial covenants. We were in compliance with the financial covenants at both June 30, 2006 and December 31, 2005 and expect to continue to remain in compliance with such financial covenants. This line of credit expires on June 30, 2007. We believe the line of credit will be renewed at that time.

We provide our services in 44 states and we are subject to numerous local taxing jurisdictions within those states. Consequently, the taxability of our

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services is subject to various interpretations within these jurisdictions. In the ordinary course of business, a jurisdiction may contest our reporting positions with respect to the application of its tax code to our services, which may result in additional tax liabilities.

At both June 30, 2006 and December 31, 2005 we have unsettled tax assessments from a state taxing authority of \$550,000 (\$358,000, net of federal income taxes). With respect to these assessments, we have recorded a reserve at June 30, 2006 of \$275,000 (\$175,000 net of federal income taxes) and at December 31, 2005 of \$155,000 (\$100,000 net of federal income taxes).

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In other tax matters, because of the uncertainties related to both the probable outcome and amount of probable assessment due, we are unable to make a reasonable estimate of a liability. We do not expect the resolution of any of these matters, taken individually or in the aggregate, to have a material adverse affect on our consolidated financial position or results of operations.

We are involved in miscellaneous claims and litigation arising in the ordinary course of business. We believe that these matters, taken individually or in the aggregate, would not have a material adverse effect on our financial position or consolidated results of operations.

The Balance Budget Act of 1997 changed Medicare policy in a number of ways, most notably the phasing in, effective July 1, 1998, of a Medicare Prospective Payment System for skilled nursing facilities which significantly changed the manner and the amounts of reimbursement they receive. Many of our clients' revenues are highly contingent on Medicare and Medicaid reimbursement funding rates. Therefore, they have been and continue to be adversely affected by changes in applicable laws and regulations, as well as other trends in the long-term care industry. This has resulted in certain of our clients filing for bankruptcy protection. Others may follow. These factors, in addition to delays in payments from clients, have resulted in and could continue to result in significant additional bad debts in the near future.

NOTE 3 - SEGMENT INFORMATION

REPORTABLE OPERATING SEGMENTS

We manage and evaluate our operations in two reportable segments. The two reportable segments are Housekeeping (housekeeping, laundry, linen and other services), and Food (food services). Although both segments serve the same client base and share many operational similarities, they are managed separately due to distinct differences in the type of service provided, as well as the specialized expertise required of the professional management personnel responsible for delivering the respective segment's services. We consider the various services provided within Housekeeping to be one reportable operating segment since such services are rendered pursuant to a single service agreement and the delivery of such services is managed by the same management personnel.

Differences between the reportable segments' operating results and other disclosed data and our consolidated financial statements relate primarily to corporate level transactions, as well as transactions between reportable segments and our warehousing and distribution subsidiary. The subsidiary's transactions with reportable segments are made on a basis intended to reflect the fair market value of the goods transferred. Additionally, included in the differences between the reportable segments' operating results and other disclosed data are amounts attributable to our investment holding company

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subsidiary. This subsidiary does not transact any business with the reportable segments. Segment amounts reported are prior to any elimination entries made in consolidation.

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Housekeeping provides services in Canada, although essentially all of its revenues and net income, 99% in both categories, are earned in one geographic area, the United States. Food provides services solely in the United States.

| | Housekeeping services ----- | Food services ----- | Corporate and eliminations ----- | Total ----- |
|-----------------------------------|-----------------------------------|---------------------------|--|----------------|
| Quarter Ended June 30, 2006 | | | | |
| Revenues | \$ 98,291,000 | \$24,673,000 | \$ (124,000) | \$122,840,000 |
| Income before income taxes | \$ 9,436,000 | \$ 915,000 | \$ (504,000) (1) | \$ 9,847,000 |
| Quarter Ended June 30, 2005 | | | | |
| Revenues | \$ 93,275,000 | \$22,924,000 | \$ (151,000) | \$116,048,000 |
| Income before income taxes | \$ 8,152,000 | \$ 785,000 | \$ (1,544,000) (1) | \$ 7,393,000 |
| Six Months Ended June 30, 2006 | | | | |
| Revenues | \$193,150,000 | \$47,712,000 | \$ 896,000 | \$241,758,000 |
| Income before income taxes | \$ 18,851,000 | \$ 1,617,000 | \$ (1,429,000) (1) | \$ 19,039,000 |
| Six Months Ended June 30, 2005 | | | | |
| Revenues | \$184,365,000 | \$45,539,000 | \$ 839,000 | \$230,743,000 |
| Income before income taxes | \$ 16,433,000 | \$ 1,430,000 | \$ (3,594,000) (1) | \$ 14,269,000 |

(1) represents primarily corporate office cost and related overhead, as well as consolidated subsidiaries' operating expenses that are not allocated to the reportable segments.

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TOTAL REVENUES FROM CLIENTS

The following revenues earned from clients differ from segment revenues reported above due to the inclusion of adjustments used for segment reporting purposes by management. We earned total revenues from clients in the following service categories:

| For the Quarter Ended June 30, | |
|-----------------------------------|---------------|
| ----- 2006 | 2005 ----- |
| ----- | ----- |

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| | | |
|--------------------------------|---------------|---------------|
| Housekeeping services | \$ 69,039,000 | \$ 65,485,000 |
| Laundry and linen services | 28,880,000 | 27,367,000 |
| Food Services | 24,301,000 | 22,631,000 |
| Maintenance services and Other | 620,000 | 565,000 |
| | ----- | ----- |
| | \$122,840,000 | \$116,048,000 |
| | ===== | ===== |

For the Six Months Ended
June 30,

| | | |
|--------------------------------|---------------|---------------|
| | ----- | ----- |
| | 2006 | 2005 |
| | ----- | ----- |
| Housekeeping services | \$136,347,000 | \$129,944,000 |
| Laundry and linen services | 56,971,000 | 54,459,000 |
| Food Services | 47,210,000 | 45,068,000 |
| Maintenance services and Other | 1,230,000 | 1,272,000 |
| | ----- | ----- |
| | \$241,758,000 | \$230,743,000 |
| | ===== | ===== |

MAJOR CLIENT

We have one client, a nursing home chain (the "Major Client"), which accounted for 19% of total revenues in each of the three month periods ended June 30, 2006 and June 30, 2005. Additionally, in the three month period ended June 30, 2006, we derived 17% and 27%, respectively, of Housekeeping and Food's revenues from such client. This client completed its previously announced merger on March 14, 2006. Our relationship with the successor entity remains under the same terms and conditions as established prior to the merger. Although we expect to continue the relationship with this client's successor, there can be no assurance thereof, and the loss of such client would have a material adverse effect on the results of operations of our two operating segments. In addition, if such client's successor changes its payment terms it would increase our accounts receivable balance and have a material adverse effect on our cash flows and cash and cash equivalents.

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NOTE 4 - EARNINGS PER COMMON SHARE

A reconciliation of the numerator and denominator of basic and diluted earnings per common share is as follows:

| | | | |
|--------------------------------------|-----------------------------|---------------|-----------|
| | Quarter Ended June 30, 2006 | | |
| | ----- | ----- | ----- |
| | Income | Shares | Per-share |
| | (Numerator) | (Denominator) | Amount |
| | ----- | ----- | ----- |
| Net income | \$6,203,000 | | |
| | ===== | | |
| Basic earnings per common share | \$6,203,000 | 27,414,000 | \$.23 |
| Effect of dilutive securities: | | | |
| Options | | 1,277,000 | (.01) |
| | ----- | ----- | ----- |
| Diluted earnings per common share | \$6,203,000 | 28,691,000 | \$.22 |
| | ===== | ===== | ===== |

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| Quarter Ended June 30, 2005 | | | |
|--------------------------------------|-----------------------|-------------------------|---------------------|
| | Income (Numerator) | Shares (Denominator) | Per-share Amount |
| Net income | \$4,584,000 | | |
| ===== | | | |
| Basic earnings per common share | \$4,584,000 | 26,878,000 | \$.17 |
| Effect of dilutive securities: | | | |
| Options | | 1,526,000 | (.01) |
| ----- | | | |
| Diluted earnings per common share | \$4,584,000 | 28,404,000 | \$.16 |
| ===== | | | |

| Six Months Ended June 30, 2006 | | | |
|--------------------------------------|-----------------------|-------------------------|---------------------|
| | Income (Numerator) | Shares (Denominator) | Per-share Amount |
| Net income | \$11,994,000 | | |
| ===== | | | |
| Basic earnings per common share | \$11,994,000 | 27,367,000 | \$.44 |
| Effect of dilutive securities: | | | |
| Options | | 1,289,000 | (.02) |
| ----- | | | |
| Diluted earnings per common share | \$11,994,000 | 28,656,000 | \$.42 |
| ===== | | | |

| Six Months Ended June 30, 2005 | | | |
|--------------------------------------|-----------------------|-------------------------|---------------------|
| | Income (Numerator) | Shares (Denominator) | Per-share Amount |
| Net income | \$8,847,000 | | |
| ===== | | | |
| Basic earnings per common share | \$8,847,000 | 26,750,000 | \$.33 |
| Effect of dilutive securities: | | | |
| Options | | 1,471,000 | (.02) |
| ----- | | | |
| Diluted earnings per common share | \$8,847,000 | 28,221,000 | \$.31 |
| ===== | | | |

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Options to purchase 426,000 and 424,000 shares of common stock at an average exercise price of \$20.71 were outstanding during the three and six month periods ended June 30, 2006, respectively, but not included in the computation of diluted earnings per common share because the options' exercise prices were greater than the average market price of the common shares, and therefore, would be antidilutive. No outstanding options were excluded from the computation of diluted earnings per common share for either of the three or six month periods ended June 30, 2005 as none have an exercise price in excess of the average

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market value of our common stock during such periods.

DIVIDENDS

We have paid regular quarterly cash dividends since the second quarter of 2003. During the six month period ended June 30, 2006, we paid regular cash dividends totaling \$5,745,000 as follows.

| | 1st Quarter ----- | 2nd Quarter ----- |
|--------------------------------|----------------------|----------------------|
| Cash dividend per common share | \$.10 | \$.11 |
| Total cash dividends paid | \$2,700,000 | \$3,045,000 |
| Record date | February 3 | April 28 |
| Payment date | February 13 | May 10 |

Additionally, on July 18, 2006, our Board of Directors declared a regular quarterly cash dividend payment of \$.12 per common share to be paid on August 11, 2006 to shareholders of record as of July 28, 2006.

NOTE 5 - SHARE-BASED COMPENSATION

During the six month period ended June 30, 2006, the stock option activity under our 2002 Stock Option Plan, 1995 Incentive and Non-Qualified Stock Option Plan for key employees, and 1996 Non-Employee Director's Stock Option Plan (collectively the "Stock Option Plans"), was as follows:

| | Weighted Average Price ----- | Number of Shares ----- | Weighted Average Remaining Contractual Life (In Years) ----- | Aggregate Intrinsic Value ----- |
|------------------------------|------------------------------------|------------------------------|---|--|
| Outstanding, January 1, 2006 | \$ 8.91 | 2,843,000 | | |
| Granted | -- | -- | | |
| Cancelled | 18.09 | (5,000) | | |
| Exercised | 8.53 | (189,000) | | |
| | ----- | ----- | | |
| Outstanding, June 30, 2006 | \$ 8.92 ===== | 2,649,000 ===== | 5.78 ===== | \$31,877,000 ===== |

The following table summarizes information about stock options outstanding at June 30, 2006.

| Exercise Price Range | Number Outstanding | Options Outstanding | | Options Exercisable | |
|-------------------------|-----------------------|--|---|--------------------------------|---|
| | | Average Remaining Contractual Life ----- | Weighted Average Exercise Price ----- | Number Exercisable ----- | Weighted Average Exercise Price ----- |
| \$ 2.25 - 3.75 | 522,000 | 3.36 | \$ 3.08 | 522,000 | \$ 3.08 |
| \$ 4.11 - 5.62 | 852,000 | 5.70 | 4.66 | 852,000 | 4.66 |
| \$ 8.29 - 8.29 | 435,000 | 7.49 | 8.29 | 435,000 | 8.29 |
| \$13.65 - 20.71 | 840,000 | 6.50 | 17.18 | 840,000 | 17.18 |
| | ----- | ----- | ----- | ----- | ----- |

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| | | | | |
|-----------|-------|---------|-----------|---------|
| 2,649,000 | 5.78 | \$ 8.92 | 2,649,000 | \$ 8.92 |
| ===== | ===== | ===== | ===== | ===== |

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Other information pertaining to option activity during the six month periods ended June 30, 2006 and June 30, 2005 was as follows:

| | June 30, 2006 | June 30, 2005 |
|--|------------------|------------------|
| | ----- | ----- |
| Weighted average grant-date fair value of stock options granted: | Not applicable | Not applicable |
| Total pre-tax fair value of stock options vested: | Not applicable | \$2,294,000 |
| Total pre-tax intrinsic value of stock options exercised: | \$2,151,000 | \$7,339,000 |

Under our Plans at June 30, 2006, in addition to the 2,649,000 issuable pursuant to outstanding option grants, an additional 1,728,000 shares of our Common Stock are available for future grants. Options outstanding and exercisable were granted at a stock option price which was not less than the fair market value of our Common Stock on the date the option was granted and no option has a term in excess of ten years. Additionally, options vested and became exercisable either on the date of grant or commencing six months from the option grant date.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, Share-Based Payment ("SFAS No. 123R" or the "Statement"). This Statement is a revision of SFAS No. 123, Accounting for Stock-Based Compensation ("SFAS 123"), and supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB No. 25") and its related implementation guidance. On January 1, 2006, we adopted the provisions of SFAS No. 123R using the modified prospective method. SFAS No. 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. The Statement requires entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as financing cash flows, rather than as an operating cash flow as prescribed under the prior accounting rules. This requirement reduces net operating cash flows and increases net financing cash flows in periods after adoption. Total cash flow remains unchanged from what would have been reported under prior accounting rules.

Prior to the adoption of SFAS No. 123R, we followed the intrinsic value method in accordance with APB No. 25 to account for our employee stock options and share purchase rights. Accordingly, no compensation expense was recognized for share purchase rights granted in connection with the issuance of stock options under any of our Stock Option Plans, or through our 2000 Employee Stock Purchase Plan (the "ESPP") for periods ended prior to January 1, 2006. The adoption of SFAS No. 123R primarily resulted in a change in our method of recognizing the fair value of share-based compensation. Specifically, the adoption of SFAS No. 123R has resulted in our recording compensation expense for employee stock options and ESPP rights.

The pre-tax share-based employee compensation expense recorded in the three and six month periods ended June 30, 2006 was approximately \$35,000 and

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\$116,000, respectively. Such expense resulted solely from the estimated value to be recognized from the share-based payments

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of our ESPP. It is estimated, at this time, that the expense attributable to such share-based payments in each of the remaining quarters of 2006 will approximate the average of the amounts recorded in the 2006 first and second quarter. Such future expense will be impacted by and dependent on the change in our stock price over the remaining period up to the December 31, 2006 measurement date. Additionally, we do not expect to grant any employee options and therefore recognize any share-based payments' expense from the issuance of employee stock options in 2006 until the fourth quarter. Although such impact is expected to be material, the impact cannot be reasonably estimated because it will depend on certain factors which are not fully known at this time. The options outstanding at December 31, 2005 did not and will not impact 2006 consolidated results of operations and financial position since all option-holders were fully vested in such options at December 31, 2005.

The fair market value of the shared-based payments of our ESPP for the three and six month periods ended June 30, 2006 were estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

| | |
|---|-------|
| Risk-free interest rate | 4.5% |
| Expected volatility | 34.5% |
| Weighted average expected life (in years) | .5 |
| Dividend yield | 2.1% |

Results for the three and six month periods ended June 30, 2005 have not been restated. Had compensation expense for employee stock options granted under our Stock Option Plans and share purchase rights under our ESPP been determined based on fair value at the grant date consistent with SFAS No. 123, our net income and earnings per share for such 2005 periods would have been the pro forma amounts indicated below:

| | Quarter Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|--|--------------------------------|-----------------------------------|
| | ----- | ----- |
| Net Income | | |
| As reported | \$4,584,000 | \$ 8,847,000 |
| Deduct: Total share-based employee compensation expense determined under fair value based method for all awards, net of related tax effects: | | |
| Stock Option Plans | (680,000) | (1,699,000) |
| ESPP | (151,000) (1) | (302,000) (1) |
| | ----- | ----- |
| Pro forma net income | \$3,753,000 | \$ 6,846,000 |
| | ===== | ===== |
| Basic Earnings Per Common Share | | |
| As reported | \$.17 | \$.33 |
| Pro forma | \$.14 | \$.26 |
| Diluted Earnings Per Common Share | | |
| As reported | \$.16 | \$.31 |
| Pro forma | \$.13 | \$.24 |

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- (1) Represents actual 2005 share-based compensation applicable to the ESPP allocated to the three and six month periods ended June 30, 2005, respectively.

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NOTE 6 - RELATED PARTY TRANSACTIONS

One of our directors, as well as the brother of an officer and director (collectively "Related Parties"), have separate ownership interests in several different client facilities which have entered into service agreements with us. During the six month periods' ended June 30, 2006 and June 30, 2005, the service agreements with the client facilities in which the Related Parties have ownership interests resulted in revenues of \$3,963,000 and \$3,805,000, respectively. At June 30, 2006 and December 31, 2005, accounts and notes receivable from such facilities of \$2,764,000 and \$2,343,000, respectively, are included in the accompanying consolidated balance sheets. During 2005, we were issued interest bearing promissory notes in the aggregate amount of \$1,200,000 for the obligations due from facilities operated by the brother of an officer and director. The subject accounts and notes receivable balances due from the Related Parties are within agreed upon payment terms.

Another of our directors is a member of a law firm which was retained by us. During the six month periods' ended June 30, 2006 and June 30, 2005, fees received from us by such firm did not exceed \$75,000 in either period. Additionally, such fees did not exceed, in either period, 5% of such firm's revenues.

NOTE 7 - RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the Financial Accounting Standards Board (the "FASB") issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENT REGARDING FORWARD LOOKING STATEMENTS

This report includes forward-looking statements that are subject to risks and uncertainties that could cause actual results or objectives to differ materially from those projected. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Such risks and uncertainties include, but are not limited to, risks arising from our providing services exclusively to the health care industry, primarily providers of long-term care; credit and collection risks associated with this industry; one client accounting for approximately 19% of revenues in the six month period ended June 30, 2006 (such client has completed its previously announced merger on March 14, 2006); our claims experience related to workers' compensation and general liability insurance; the

effects of changes in, or interpretations of laws and regulations governing the industry, including state and local regulations pertaining to the taxability of our services; and the risk factors described in our Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2005 and in Part I thereof under "Government Regulation of Clients", "Competition", "Service Agreements/Collections" and "Risk Factors". Many of our clients' revenues are highly contingent on Medicare and Medicaid reimbursement funding rates, which have been and continue to be adversely affected by the change in Medicare payments under the 1997 enactment of the Medicare Prospective Payment System. That change, and the lack of substantive reimbursement funding rate reform legislation, as well as other trends in the long-term care industry have resulted in certain of our clients filing for bankruptcy protection. Others may follow. Any decisions by the government to discontinue or adversely modify legislation related to reimbursement funding rates will have a material adverse effect on our clients. These factors, in addition to delays in payments from clients, have resulted in, and could continue to result in, significant additional bad debts in the near future. Additionally, our operating results would be adversely affected if unexpected increases in the costs of labor and labor related costs, materials, supplies and equipment used in performing services could not be passed on to our clients.

In addition, we believe that to improve our financial performance we must continue to obtain service agreements with new clients, provide new services to existing clients, achieve modest price increases on current service agreements with existing clients and maintain internal cost reduction strategies at our various operational levels. Furthermore, we believe that our ability to sustain the internal development of managerial personnel is an important factor impacting future operating results and successfully executing projected growth strategies.

RESULTS OF OPERATIONS

The following discussion is intended to provide the reader with information that will be helpful in understanding our financial statements including the changes in certain key items in comparing financial statements period to period. We also intend to provide the primary factors that accounted for those changes, as well as a summary of how certain accounting principles affect our financial statements. In addition, we are providing information about the financial results of our two operating segments to further assist in understanding how these segments and their results affect our consolidated results of operations. This discussion should be read in conjunction with our financial statements as of June 30, 2006 and December 31, 2005 and the periods then ended, and the notes accompanying those financial statements.

OVERVIEW

We provide housekeeping, laundry, linen, facility maintenance and food services to the health care industry, including nursing homes, retirement complexes, rehabilitation centers and hospitals located throughout the United States. We believe that we are the largest provider of housekeeping and laundry services to the long-term care industry in the United States, rendering such services to approximately 1,725 facilities in 44 states as of June 30, 2006. Although we do not directly participate in any government reimbursement programs, our clients' reimbursements are subject to government regulation. Therefore, they are directly affected by any legislation relating to Medicare and Medicaid reimbursement programs.

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We provide our services primarily pursuant to full service agreements with our clients. In such agreements, we are responsible for the management and hourly employees located at our clients' facilities. We also provide services on the basis of a management-only agreement for a very limited number of clients. Our agreements with clients typically provide for a one year service term, cancelable by either party upon 30 to 90 days notice after the initial 90-day period.

We are organized into two reportable segments; housekeeping, laundry, linen and other services ("Housekeeping"), and food services ("Food").

The services provided by Housekeeping consist primarily of the cleaning, disinfecting and sanitizing of patient rooms and common areas of a client's facility, as well as the laundering and processing of the personal clothing belonging to the facility's patients. Also within the scope of this segment's service is the laundering and processing of the bed linens, uniforms and other assorted linen items utilized by a client facility.

Food, which began operations in 1997, consists of providing for the development of a menu that meets the patient's dietary needs, and the purchasing and preparing of the food for delivery to the patients.

Additionally, we operate two wholly-owned subsidiaries, HCSG Supply, Inc. ("Supply") and Huntingdon Holdings, Inc. ("Huntingdon"). Supply purchases, warehouses and distributes the supplies and equipment used in providing our Housekeeping segment services. Huntingdon invests our cash and cash equivalents.

CONSOLIDATED OPERATIONS

The following table sets forth, for the periods indicated, the percentage which certain items bear to consolidated revenues:

| | Relation to Consolidated Revenues | | | |
|--|-----------------------------------|--------|--------------------------------------|--------|
| | For the Quarter Ended June 30, | | For the Six Months Ended June 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Operating costs and expenses: | | | | |
| Costs of services provided | 86.2 | 87.3 | 86.1 | 87.2 |
| Selling, general and administration | 6.6 | 7.0 | 7.0 | 7.1 |
| Investment and interest income | .8 | .7 | 1.0 | .5 |
| Income before income taxes | 8.0 | 6.4 | 7.9 | 6.2 |
| Income taxes | 3.0 | 2.4 | 2.9 | 2.4 |
| Net income | 5.0% | 4.0% | 5.0% | 3.8% |

Subject to the factors noted in the Cautionary Statement Regarding Forward Looking Statements included in this report, we anticipate our financial performance for the remainder of 2006 to be comparable to the six month period ended June 30, 2006 percentages presented in the above table as they relate to consolidated revenues.

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Housekeeping is our largest and core reportable segment, representing approximately 80%

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of consolidated revenues for both the quarter and six month period ended June 30, 2006. Food revenues represented approximately 20% of consolidated revenues for such periods.

Although there can be no assurance thereof, we believe that for the remainder of 2006 each of Housekeeping's and Food's revenues, as a percentage of consolidated revenues, will remain approximately the same as their respective percentages noted above. Furthermore, we expect the sources of growth for the remainder of 2006 for the respective operating segments will be primarily the same as historically experienced. Accordingly, although there can be no assurance thereof, the growth in Food is expected to come from our current Housekeeping client base, while growth in Housekeeping will primarily come from obtaining new clients.

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2006 SECOND QUARTER COMPARED WITH 2005 SECOND QUARTER

The following table sets forth 2006 second quarter income statement key components that we use to evaluate our financial performance on a consolidated and reportable segment basis, as well as the percentage increases of each compared to 2005 second quarter amounts.

| | Consolidated | Percent increase | Corporate and eliminations | Reportable Segment | | A |
|---|---------------|------------------|----------------------------|------------------------|-------|-------|
| | | | | Housekeeping Amount | %incr | |
| Revenues | \$122,840,000 | 5.9% | \$ (124,000) | \$98,291,000 | 5.4% | \$24, |
| Cost of services provided | 105,843,000 | 4.4 | 6,770,000 | 88,855,000 | 4.4 | 23, |
| Selling, general and administrative expense | 8,123,000 | .2 | (8,123,000) | -- | | |
| Income before income taxes | \$ 9,847,000 | 33.2% | (504,000) | \$ 9,436,000 | 15.8 | \$ |

REVENUES

Consolidated

Consolidated revenues increased 5.9% to \$122,840,000 in the 2006 second quarter compared to \$116,048,000 in the 2005 second quarter as a result of the factors discussed below under Reportable Segments.

Our Major Client accounted for 19% of consolidated revenues in each of the three month periods ended June 30, 2006 and June 30, 2005. This client completed its previously announced merger on March 14, 2006. Our relationship with the

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successor entity remains under the same terms and conditions as established prior to the merger. Although we expect to continue the relationship with this client's successor, there can be no assurance thereof, and the loss of such client would have a material adverse effect on the results of operations of our two operating segments. In addition, if such client's successor changes its payment terms it would increase our accounts receivable balance and have a material adverse effect on our cash flows and cash and cash equivalents.

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Reportable Segments

Housekeeping's 5.4% net growth in reportable segment revenues is primarily a result of an increase in service agreements entered into with new clients.

Food's 7.6% net growth in reportable segment revenues is a result of providing this service to existing Housekeeping clients.

We derived 17% and 27%, respectively, of Housekeeping and Food's 2006 second quarter revenues from the Major Client.

COSTS OF SERVICES PROVIDED

Consolidated

Cost of services provided, on a consolidated basis, as a percentage of consolidated revenues for the 2006 second quarter decreased to 86.2 % from 87.3 % in the corresponding 2005 quarter. The following table provides a comparison of the primary cost of services provided-key indicators that we manage on a consolidated basis in evaluating our financial performance

| Cost of Services Provided-Key Indicators | 2006 % | 2005 % | (Decr) % |
|---|--------|--------|----------|
| Bad debt provision | .2 | .2 | -- |
| Workers' compensation and general liability insurance | 4.0 | 4.3 | (.3) |

The decrease in workers' compensation and general liability insurance is primarily a result of reduced payments to claimants due to improved claims' experience.

Reportable Segments

Cost of services provided for Housekeeping, as a percentage of Housekeeping revenues, for the 2006 second quarter decreased to 90.4% from 91.3% in the corresponding 2005 quarter. Cost of services provided for Food, as a percentage of Food revenues, for the 2006 second quarter decreased to 96.3% from 96.6% in the corresponding 2005 quarter.

The following table provides a comparison of the primary cost of services provided-key indicators, as a percentage of the respective segment's revenues, that we manage on a reportable segment basis in evaluating our financial performance:

| Cost of Services Provided-Key Indicators | 2006 % | 2005 % | Incr (Decr) % |
|--|--------|--------|---------------|
| Housekeeping labor and other labor costs | 81.4 | 82.4 | (1.0) |
| Housekeeping supplies | 5.4 | 5.7 | (.3) |
| Food labor and other labor costs | 54.3 | 54.4 | (.1) |

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| | | | |
|---------------|------|------|------|
| Food supplies | 37.0 | 37.3 | (.3) |
|---------------|------|------|------|

The decrease in Housekeeping labor and other labor costs, as a percentage of Housekeeping revenues, resulted primarily from efficiencies achieved. The decrease in Housekeeping supplies resulted primarily from price decreases in the cost of supplies for our laundry services.

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The decrease in Food supplies, as a percentage of Food revenues, is a result of price decreases in vendor purchasing agreements.

CONSOLIDATED SELLING, GENERAL AND ADMINISTRATIVE EXPENSE

Even though we had a 5.9% growth in consolidated revenues, selling, general and administrative expenses increased by only .2% or \$14,000. As a percentage of total consolidated revenues, these expenses decreased to 6.6% in the 2006 second quarter as compared to 7.0% in the 2005 second quarter. The decrease is primarily attributable to our ability to control these expenses and comparing them to a greater revenue base in the current quarter.

INCOME BEFORE INCOME TAXES

Consolidated

As a result of the discussion above related to revenues and expenses, consolidated income before income taxes for the 2006 second quarter increased to 8.0 %, as a percentage of consolidated revenues, compared to 6.4% in the 2005 second quarter.

Reportable Segments

Housekeeping's 15.8% increase in income before income taxes is attributable to the improvement in the gross profit earned at the client facility level and the gross profit earned on the 5.4% increase in reportable segment revenues.

Food's income before income taxes increased 16.6% on a reportable segment basis which is primarily attributable to an improvement in the gross profit earned at the client facility level and the gross profit earned on the 7.6% increase in reportable segment revenues.

CONSOLIDATED INVESTMENT AND INTEREST INCOME

Investment and interest income, as a percentage of consolidated revenues, was .8% in the 2006 second quarter compared to .7% in the 2005 second quarter. The slight net increase is attributable to improved rates of return on the higher cash and cash equivalents' average balances, which was offset by the decrease in market value of the investments held in our Deferred Compensation Fund.

CONSOLIDATED INCOME TAXES

Our effective tax rate for the quarter ended June 30, 2006 was 37% compared to our June 30, 2005 effective tax rate of 38%. The decrease in the effective tax rate is primarily a result of a reduction in the state and local effective tax rate. Absent any significant change in federal, or state and local tax laws, we expect our effective tax rate for the remainder of 2006 to be approximately the same as realized in the 2006 second quarter. Our 37% effective tax rate differs from the federal income tax statutory rate principally because of the

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effect of state and local income taxes.

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CONSOLIDATED NET INCOME

As a result of the matters discussed above, consolidated net income for the 2006 second quarter increased to 5.0%, as a percentage of consolidated revenues, compared to 4.0% in the 2005 second quarter.

2006 SIX MONTH PERIOD COMPARED WITH 2005 SIX MONTH PERIOD

The following table sets forth, for the six month period ended June 30, 2006 income statement key components that we use to evaluate our financial performance on a consolidated and reportable segment basis, as well as the percentage increases of each compared to the six month period ended June 30, 2005 amounts.

| | Consolidated | Percent increase | Corporate and eliminations | Reportable Seg | | A |
|--|---------------|---------------------|-------------------------------|------------------------|-------|-------|
| | | | | Housekeeping Amount | %incr | |
| Revenues | \$241,758,000 | 4.8% | \$ 896,000 | \$193,150,000 | 4.8% | \$47, |
| Cost of services provided | 208,025,000 | 3.4 | 12,369,000 | 174,299,000 | 3.8 | 46, |
| Selling, general and administrative expense | 17,014,000 | 2.9 | (17,014,000) | -- | | |
| Income before income taxes | \$ 19,039,000 | 33.4% | (1,429,000) | \$ 18,851,000 | 14.7 | \$ 1, |

REVENUES

Consolidated

Consolidated revenues increased 4.8% to \$241,758,000 in the six month period ended June 30, 2006 compared to \$230,743,000 in the same 2005 period as a result of the factors discussed below under Reportable Segments.

Our Major Client accounted for 19% of consolidated revenues in each of the six month periods ended June 30, 2006 and June 30, 2005.

Reportable Segments

Housekeeping's 4.8% net growth in reportable segment revenues is primarily a result of an increase in service agreements entered into with new clients.

Food's 4.8% net growth in reportable segment revenues is a result of providing this service to existing Housekeeping clients.

We derived 17% and 27%, respectively, of Housekeeping and Food's 2006 six month period's revenues from the Major Client.

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COSTS OF SERVICES PROVIDED

Consolidated

Cost of services provided, on a consolidated basis, as a percentage of consolidated revenues for the six month period ended June 30, 2006 decreased to 86.1% from 87.2% in the corresponding 2005 period. The following table provides a comparison of the primary cost of services provided-key indicators that we manage on a consolidated basis in evaluating our financial performance

| Cost of Services Provided-Key Indicators | 2006 % | 2005 % | (Decr) % |
|---|--------|--------|----------|
| Bad debt provision | .3 | .3 | -- |
| Workers' compensation and general liability insurance | 3.8 | 4.3 | (.5) |

The decrease in workers' compensation and general liability insurance is primarily a result of reduced payments to claimants due to improved claims' experience.

Reportable Segments

Cost of services provided for Housekeeping, as a percentage of Housekeeping revenues, for the six month period ended June 30, 2006 decreased to 90.2% from 91.1% in the corresponding 2005 period. Cost of services provided for Food, as a percentage of Food revenues, for the 2006 six month period decreased to 96.6% from 96.9% in the corresponding 2005 six month period.

The following table provides a comparison of the primary cost of services provided-key indicators, as a percentage of the respective segment's revenues, that we manage on a reportable segment basis in evaluating our financial performance:

| Cost of Services Provided-Key Indicators | 2006 % | 2005 % | Incr (Decr) % |
|--|--------|--------|---------------|
| Housekeeping labor and other labor costs | 81.3 | 82.1 | (.8) |
| Housekeeping supplies | 5.4 | 5.2 | .2 |
| Food labor and other labor costs | 54.4 | 54.3 | .1 |
| Food supplies | 37.3 | 39.7 | (2.4) |

The decrease in Housekeeping labor and other labor costs, as a percentage of Housekeeping revenues, resulted primarily from efficiencies achieved. The increase in Housekeeping supplies resulted primarily from vendor price increases.

The decrease in Food segment supplies, as a percentage of Food segment revenues, is a result of price decreases in vendor purchasing agreements.

CONSOLIDATED SELLING, GENERAL AND ADMINISTRATIVE EXPENSE

Consistent with our 4.8% growth in consolidated revenues, selling, general and administrative expenses increased by 2.9% or \$476,000 in comparing the six month periods ended June 30, 2006 and June 30, 2005. However, as a percentage of total consolidated revenues, these expenses decreased by .1% to 7.0% in the 2006 period as compared to 7.1% in the 2005 period. The decrease is primarily attributable to our ability to control these expenses and comparing them to a greater revenue base in the current six month period.

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INCOME BEFORE INCOME TAXES

Consolidated

As a result of the discussion above related to revenues and expenses, consolidated income before income taxes for the six month period ended June 30, 2006 increased to 7.9 %, as a percentage of consolidated revenues, compared to 6.2% in the same 2005 period.

Reportable Segments

Housekeeping's 14.7% increase in income before income taxes is attributable to the improvement in the gross profit earned at the client facility level and the gross profit earned on the 4.8% increase in reportable segment revenues.

Food's income before income taxes increased 13.1% on a reportable segment basis which is primarily attributable to an improvement in the gross profit earned at the client facility level and the gross profit earned on the 4.8% increase in reportable segment revenues.

CONSOLIDATED INVESTMENT AND INTEREST INCOME

Investment and interest income, as a percentage of consolidated revenues, was 1.0% in the six month period ended June 30, 2006 compared to .5% in the same 2005 period. The slight net increase is attributable to improved rates of return on the higher cash and cash equivalents' average balances, which was offset by the decrease in the market value of the investments held in our Deferred Compensation Fund.

CONSOLIDATED INCOME TAXES

Our effective tax rate for the six month period ended June 30, 2006 was 37% compared to our June 30, 2005 effective tax rate of 38%. The decrease in the effective tax rate is primarily a result of a reduction in the state and local effective tax rate. Absent any significant change in federal, or state and local tax laws, we expect our effective tax rate for the remainder of 2006 to be approximately the same as realized in the 2006 six month period. Our 37% effective tax rate differs from the federal income tax statutory rate principally because of the effect of state and local income taxes.

CONSOLIDATED NET INCOME

As a result of the matters discussed above, consolidated net income for the six months ended June 30, 2006 increased to 5.0%, as a percentage of consolidated revenues, compared to 3.8% in six month period ended June 30, 2005.

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CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with accounting standards generally accepted in the United States 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 period. We consider the two policies discussed below to be critical to an understanding of our financial statements

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because their application places the most significant demands on managements' judgment. Therefore, it should be noted that financial reporting results rely on estimating the effect of matters that are inherently uncertain. Specific risks for these critical accounting policies and estimates are described in the following paragraphs. For these estimates, we caution that future events rarely develop exactly as forecasted, and the best estimates routinely require adjustment. Any such adjustments or revisions to estimates could result in material differences to previously reported amounts.

The two policies discussed are not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting standards generally accepted in the United States, with no need for our judgment in their application. There are also areas in which our judgment in selecting another available alternative would not produce a materially different result. See our audited consolidated financial statements and notes thereto which are included in our Annual Report for the year ended December 31, 2005, which contain critical accounting policies and estimates and other disclosures required by accounting principles generally accepted in the United States.

ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Allowance for Doubtful Accounts is established as losses are estimated to have occurred through a provision for bad debts charged to earnings. The Allowance for Doubtful Accounts is evaluated based on our periodic review of accounts and notes receivable and is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

We have had varying collection experience with respect to our accounts and notes receivable. When contractual terms are not met, we generally encounter difficulty in collecting amounts due from certain of our clients. Therefore, we have sometimes been required to extend the period of payment for certain clients beyond contractual terms. These clients include those who have terminated service agreements and slow payers experiencing financial difficulties. In making credit evaluations, in addition to analyzing and anticipating, where possible, the specific cases described above, we consider the general collection risks associated with trends in the long-term care industry. We also establish credit limits, perform ongoing credit evaluation, and monitor accounts to minimize the risk of loss.

In accordance with the risk of extending credit, we regularly evaluate our accounts and notes receivable for impairment or loss of value and when appropriate, will provide in our Allowance for Doubtful Accounts for such receivables. We generally follow a policy of reserving for receivables from clients in bankruptcy, clients with which we are in litigation for collection

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and other slow paying clients. The reserve is based upon our estimates of ultimate collectibility. Correspondingly, once our recovery of a receivable is determined through either litigation, bankruptcy proceedings or negotiation to be less than the recorded amount on our balance sheet, we will charge-off the applicable amount to the Allowance for Doubtful Accounts.

At June 30, 2006, we identified accounts totaling \$3,157,000 that require an Allowance for Doubtful Accounts based on potential impairment or loss of value. An Allowance for Doubtful Accounts totaling \$2,720,000 was provided for these accounts at such date. Actual collections of these accounts could differ

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from that which we currently estimate. If our actual collection experience is 5% less than our estimate, the related increase to our Allowance for Doubtful Accounts would decrease net income by \$14,000.

Notwithstanding our efforts to minimize credit risk exposure, our clients could be adversely affected if future industry trends, as more fully discussed under Liquidity and Capital Resources below, and as further described in our Form 10-K filed with Securities and Exchange Commission for the year ended December 31, 2005 in Part I thereof under "Government Regulation of Clients", "Service Agreements/Collections" and "Risk Factors", change in such a manner as to negatively impact the cash flows of our clients. If our clients experience a negative impact in their cash flows, it would have a material adverse effect on our results of operations and financial condition.

ACCRUED INSURANCE CLAIMS

We currently have a Paid Loss Retrospective Insurance Plan for general liability and workers' compensation insurance, which comprise approximately 38% of our liabilities at June 30, 2006. Our accounting for this plan is affected by various uncertainties because we must make assumptions and apply judgment to estimate the ultimate cost to settle reported claims and claims incurred but not reported as of the balance sheet date. We address these uncertainties by regularly evaluating our claims pay-out experience, present value factor and other factors related to the nature of specific claims in arriving at the basis for our accrued insurance claims estimate. Our evaluations are based primarily on current information derived from reviewing our claims experience and industry trends. In the event that our claims experience and/or industry trends result in an unfavorable change, it would have a material adverse effect on our consolidated results of operations and financial condition. Under these plans, pre-determined loss limits are arranged with an insurance company to limit both our per-occurrence cash outlay and annual insurance plan cost.

For workers' compensation, we record a reserve based on the present value of future payments, including an estimate of claims incurred but not reported, that are developed as a result of a review of our historical data and open claims. The present value of the payout is determined by applying an 8% discount factor against the estimated value of the claims over the estimated remaining pay-out period. Reducing the discount factor by 1% would reduce net income by approximately \$41,000. Additionally, reducing the estimated payout period by six months would result in an approximate \$104,000 reduction in net income.

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For general liability, we record a reserve for the estimated ultimate amounts to be paid for known claims. The estimated ultimate reserve amount recorded is derived from the estimated claim reserves provided by our insurance carrier reduced by an historical experience factor.

LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2006, we had cash and cash equivalents of \$92,318,000 and working capital of \$150,748,000 compared to December 31, 2005 cash and cash equivalents of \$91,005,000 and working capital of \$142,535,000. We view our cash and cash equivalents as our principal measure of liquidity. Our current ratio at June 30, 2006 increased to 7.7 to 1 compared to 7.2 to 1 at December 31, 2005. This increase resulted primarily from the timing of payments for accrued payroll, accrued and withheld payroll taxes. On an historical basis, our operations have generally produced consistent cash flow and have required limited capital resources. We believe our current and near term cash flow

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positions will enable us to fund our continued anticipated growth.

OPERATING ACTIVITIES

The net cash provided by our operating activities was \$6,287,000 for the six month period ended June 30, 2006. The principal sources of net cash flows from operating activities for the six month period ended June 30, 2006 were net income, including non-cash charges to operations for bad debt provisions and depreciation. Additionally, operating activities' cash flows increased by \$1,438,000 as a result of the timing of payments for accounts payable and other accrued expenses. The operating activity that used the largest amount of cash during the six month period ended June 30, 2006 was a net increase of \$6,941,000 in accounts and notes receivable and long-term notes receivable resulting primarily from the 4.8% growth in the Company's 2006 six month period revenues.

INVESTING ACTIVITIES

Our principal use of cash in investing activities for the six month period ended June 30, 2006 was \$1,012,000 for the purchase of housekeeping equipment, computer software and equipment, and laundry equipment installations. Under our current plans, which are subject to revision upon further review, it is our intention to spend an aggregate of \$1,000,000 to \$1,500,000 during the remainder of 2006 for such capital expenditures.

FINANCING ACTIVITIES

We have paid regular quarterly cash dividends since the second quarter of 2003. During the six month period ended June 30, 2006, we paid regular cash dividends totaling \$5,745,000 as follows.

| | 1st Quarter | 2nd Quarter |
|--------------------------------|-------------|-------------|
| | ----- | ----- |
| Cash dividend per common share | \$.10 | \$.11 |
| Total cash dividends paid | \$2,700,000 | \$3,045,000 |
| Record date | February 3 | April 28 |
| Payment date | February 13 | May 10 |

Additionally, on July 18, 2006, our Board of Directors declared a regular quarterly cash dividend payment of \$.12 per common share to be paid on August 11, 2006 to shareholders of record as of July 28, 2006.

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Our Board of Directors reviews our dividend policy on a quarterly basis. Although there can be no assurance that we will continue to pay dividends or the amount of the dividend, we expect to continue to pay a regular quarterly cash dividend. In connection with the establishment of our dividend policy, we adopted a Dividend Reinvestment Plan in 2003.

During the six month period ended June 30, 2006, we expended \$613,000 for the repurchase of 34,000 shares of our common stock. We remain authorized to purchase 1,248,000 shares pursuant to previous Board of Directors' actions.

During the six month period ended June 30, 2006, we received proceeds of \$1,597,000 from the exercise of stock options by employees and directors, as well as recognizing an income tax benefit of \$763,000 from such stock option transactions.

LINE OF CREDIT

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We have a \$25,000,000 bank line of credit on which we may draw to meet short-term liquidity requirements in excess of internally generated cash flow. Amounts drawn under the line of credit are payable upon demand. At June 30, 2006 and December 31, 2005, there were no borrowings under the line. However, at such dates, we had outstanding \$23,925,000 and \$17,925,000, respectively, of irrevocable standby letters of credit which relate to payment obligations under our insurance programs. As a result of the letters of credit issued, the amount available under the line of credit was reduced by \$23,925,000 and \$17,925,000 at June 30, 2006 and December 31, 2005, respectively.

The line of credit requires us to satisfy two financial covenants. Such covenants, and their respective status at June 30, 2006, were as follows:

| Covenant Description and Requirement | Status at June 30, 2006 |
|---|-------------------------------------|
| ----- Commitment coverage ratio: cash and cash equivalents must equal or exceed outstanding obligations under the line by a multiple of 2. | ----- Commitment coverage is 3.9 |
| Tangible net worth: must exceed \$118,000,000. | Tangible net worth is \$154,964,000 |

As noted above, we complied with the financial covenants at June 30, 2006 and expect to continue to remain in compliance with such financial covenants. This line of credit expires on June 30, 2007. We believe the line of credit will be renewed at that time.

ACCOUNTS AND NOTES RECEIVABLE

We expend considerable effort to collect the amounts due for our services on the terms agreed upon with our clients. Many of our clients participate in programs funded by federal and state governmental agencies which historically have encountered delays in making payments to its program participants. The Balance Budget Act of 1997 changed Medicare policy in a number of ways, most notably the phasing in, effective July 1, 1998, of a Medicare Prospective Payment System for skilled nursing facilities which significantly changed the reimbursement procedures and the amounts of reimbursement our clients receive. Many of our clients' revenues are highly contingent on Medicare and Medicaid reimbursement funding rates. Therefore, they have been

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and continue to be adversely affected by changes in applicable laws and regulations, as well as other trends in the long-term care industry. This has resulted in certain of our clients filing for bankruptcy protection. Others may follow. These factors, in addition to delays in payments from clients have resulted in and could continue to result in significant additional bad debts in the near future. Whenever possible, when a client falls behind in making agreed-upon payments, we convert the unpaid accounts receivable to interest bearing promissory notes. The promissory notes receivable provide a means by which to further evidence the amounts owed and provide a definitive repayment plan and therefore may ultimately enhance our ability to collect the amounts due. At June 30, 2006 and December 31, 2005, we had \$10,189,000 and \$8,514,000, net of reserves, respectively, of such promissory notes outstanding. Additionally, we consider restructuring service agreements from full service to management-only service in the case of certain clients experiencing financial difficulties. We believe that such restructurings may provide us with a means to maintain a relationship with the client while at the same time minimizing

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collection exposure.

We have had varying collection experience with respect to our accounts and notes receivable. When contractual terms are not met, we generally encounter difficulty in collecting amounts due from certain of our clients. Therefore, we have sometimes been required to extend the period of payment for certain clients beyond contractual terms. These clients include those who have terminated service agreements and slow payers experiencing financial difficulties. In order to provide for these collection problems and the general risk associated with the granting of credit terms, we have recorded bad debt provisions (in an Allowance for Doubtful Accounts) of \$625,000 in each of the six month periods ended June 30, 2006 and June 30, 2005. These provisions represent approximately .3%, as a percentage of total revenues for each respective period. In making our credit evaluations, in addition to analyzing and anticipating, where possible, the specific cases described above, we consider the general collection risk associated with trends in the long-term care industry. We also establish credit limits, perform ongoing credit evaluation and monitor accounts to minimize the risk of loss. Notwithstanding our efforts to minimize credit risk exposure, our clients could be adversely affected if future industry trends change in such a manner as to negatively impact their cash flows. If our clients experience a negative impact in their cash flows, it would have a material adverse effect on our results of operations and financial condition.

At June 30, 2006, amounts due from our Major Client represented less than 1% of our accounts receivable balance.

INSURANCE PROGRAMS

We have a Paid Loss Retrospective Insurance Plan for general liability and workers' compensation insurance. Under these plans, pre-determined loss limits are arranged with an insurance company to limit both our per-occurrence cash outlay and annual insurance plan cost.

For workers' compensation, we record a reserve based on the present value of future payments, including an estimate of claims incurred but not reported, that are developed as a result of a review of our historical data and open claims. The present value of the payout is determined by applying an 8% discount factor against the estimated value of the claims over the estimated remaining pay-out period.

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For general liability, we record a reserve for the estimated ultimate amounts to be paid for known claims. The estimated ultimate reserve amount recorded is derived from the estimated claim reserves provided by our insurance carrier reduced by an historical experience factor.

We regularly evaluate our claims' pay-out experience, present value factor and other factors related to the nature of specific claims in arriving at the basis for our accrued insurance claims' estimate. Our evaluation is based primarily on current information derived from reviewing our claims experience and industry trends. In the event that our claims experience and/or industry trends result in an unfavorable change, it would have an adverse effect on our results of operations and financial condition.

CAPITAL EXPENDITURES

The level of capital expenditures is generally dependent on the number of new clients obtained. Such capital expenditures primarily consist of

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housekeeping equipment purchases, laundry and linen equipment installations, and computer hardware and software. Although we have no specific material commitments for capital expenditures through the end of calendar year 2006, we estimate that for the remainder of 2006 we will have capital expenditures of approximately \$1,000,000 to \$1,500,000 in connection with housekeeping equipment purchases and laundry and linen equipment installations in our clients' facilities, as well as expenditures relating to internal data processing hardware and software requirements. We believe that our cash from operations, existing cash and cash equivalents balance and credit line will be adequate for the foreseeable future to satisfy the needs of our operations and to fund our anticipated growth. However, should these sources not be sufficient, we would, if necessary, seek to obtain necessary working capital from such sources as long-term debt or equity financing.

MATERIAL OFF-BALANCE SHEET ARRANGEMENTS

We have no material off-balance sheet arrangements, other than our irrevocable standby letter of credit previously discussed.

EFFECTS OF INFLATION

Although there can be no assurance thereof, we believe that in most instances we will be able to recover increases in costs attributable to inflation by passing such cost increases through to our clients.

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ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Our exposure to market risk is not significant.

ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports under the Securities Exchange Act of 1934 (the "Exchange Act"), such as this Form 10-Q, is reported in accordance with Securities and Exchange Commission ("SEC") rules. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

As of June 30, 2006 (the "Evaluation Date"), we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon our evaluation, at the Evaluation Date, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to insure that information required to be disclosed in the reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and regulations.

CHANGES IN INTERNAL CONTROLS

There were no significant changes in our internal controls or to our knowledge, in other factors that could significantly affect our disclosure

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controls and procedures subsequent to the Evaluation Date.

CERTIFICATIONS

Certifications of the Principal Executive Officer and Principal Financial Officer regarding, among other items, disclosure controls and procedures are included as exhibits to this Form 10-Q.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

Not Applicable

ITEM 1A. RISK FACTORS

The materialization of any risks and uncertainties identified in our Cautionary Statement Regarding Forward Looking Statements contained herein together with those risks previously disclosed in our Form 10-K (referred to elsewhere herein) filed with the Securities and Exchange Commission for the year ended December 31, 2005 or those that are presently unforeseen, could result in significant adverse effects on our financial position, results of operations and cash flows.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

Repurchases

| | (a) | (b) | (c) | (d) |
|-----------------------|-------------------------------------|---------------------------------|--|--|
| 2006 Period | Total number of Shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Maximum number of shares that may yet be purchased under the plans or programs |
| ----- | ----- | ----- | ----- | ----- |
| April 1 to June 30 | None | | | |

ITEM 3. DEFAULTS UNDER SENIOR SECURITIES.

Not Applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Our Annual Meeting of Shareholders was held on May 23, 2006. The results were as follows.

(1) All of management's nominees for directors were elected as follows:

| Director | Shares voted "FOR" | Withheld |
|---------------------|-----------------------|-----------|
| ----- | ----- | ----- |
| Daniel P. McCartney | 20,538,623 | 5,042,777 |

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| | | |
|---------------------|------------|-----------|
| Barton D. Weisman | 24,293,580 | 1,287,820 |
| Joseph F. McCartney | 18,687,853 | 6,893,547 |
| Robert L. Frome | 18,990,195 | 6,591,205 |
| Thomas A. Cook | 20,068,899 | 5,512,501 |
| Robert J. Moss | 22,178,646 | 3,402,754 |
| John M. Briggs | 24,209,997 | 1,371,403 |

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(2) Proposal to approve and ratify selection of Grant Thornton LLP as the independent certified public accountants of the Company for its fiscal year ending December 31, 2006 was approved as follows:

| Shares Voted "FOR" | Shares Voted "AGAINST" | Shares "ABSTAINING" | Broker Non-votes |
|-----------------------|---------------------------|------------------------|---------------------|
| 25,258,105 | 154,376 | 168,918 | -0- |

ITEM 5. OTHER INFORMATION.

a) None

ITEM 6. EXHIBITS

a) Exhibits -

- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant had duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HEALTHCARE SERVICES GROUP, INC.

July 21, 2006
Date

/s/ Daniel P. McCartney

DANIEL P. McCARTNEY, Chief
Executive Officer

July 21, 2006

/s/ Thomas A. Cook

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Date -----
THOMAS A. COOK, President and
Chief Operating Officer

July 21, 2006 /s/ James L. DiStefano
Date -----
JAMES L. DiSTEFANO, Chief Financial
Officer and Treasurer

July 21, 2006 /s/ Richard W. Hudson
Date -----
RICHARD W. HUDSON, Vice
President-Finance, Secretary and Chief
Accounting Officer