HEALTHCARE SERVICES GROUP INC
Form 10-K
February 23, 2007

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

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE REQUIRED)**
For the transition period from to

Commission file number. 0-12015

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

Pennsylvania	**23-2018365**
(State or other jurisdiction of incorporated or organization)	*(IRS Employer Identification No.)*
3220 Tillman Drive, Suite 300, Bensalem, PA	**19020**
(Address of principal executive offices)	*(Zip Code)*

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

Securities registered pursuant to Section 12(b) of the Act:
NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock ($.01 par value)	**NASDAQ National Market**

Title of Class	Name of each exchange on which securities registered

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES o NO þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES o NO þ

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 þ NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K þ

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The aggregate market value of the voting stock (Common Stock, $.01 par value) held by non-affiliates of the Registrant as of the close of business on June 30, 2006 was approximately $507,885,000 based on closing sale price of the Common Stock on the NASDAQ National Market on that date. The Registrant does not have any non-voting common equity.

Indicate the number of shares outstanding of each of the registrant s classes of common stock (Common Stock, $.01 par value) as of the latest practicable date (February 20, 2007). 27,621,000

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement for the Registrant s Annual Meeting of Shareholders to be held on May 22, 2007 have been incorporated by reference into Parts II and III of this Annual Report on Form 10-K.

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Part I

References made herein to we, our, us , or the Company include Healthcare Services Group, Inc. and its wholly owı subsidiaries; Summit Services Group, Inc. (whose operations were fully integrated into Healthcare Services Group, Inc. on January 1, 2007), HCSG Supply, Inc. and Huntingdon Holdings, Inc., unless the context otherwise requires.

Item I. Business.

(a) General
The Company is a Pennsylvania corporation, incorporated on November 22, 1976. 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. Based on the nature and similarities of the services provided, our business operations consist of two business segments (Housekeeping and Food). 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 1,950 facilities in 47 states as of December 31, 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.

On September 18, 2006, effective as of August 31, 2006, our wholly-owned subsidiary HCSG Merger, Inc acquired 100% of the common stock of Summit Services Group, Inc. (Summit) in a transaction accounted for under the purchase method of accounting. Summit is a provider of professional housekeeping, laundry and food services to long-term care and related facilities. We believe the acquisition of Summit expands and compliments our position of being the largest provider of such services to the long-term care industry in the United States. As of January 1, 2007, Summit s operations were fully integrated into Healthcare Services Group, Inc. Additionally, we operate two wholly-owned subsidiaries, HCSG Supply, Inc. (Supply) and Huntingdon Holdings, Inc. (Huntingdon). Supply purchases, warehouses and distributes essentially all of the supplies and equipment used in providing our Housekeeping segment services. Supply also warehouses and distributes a limited number of supply items used in providing our Food segment services. Huntingdon invests our cash and cash equivalents.

(b) Segment Information
The information called for herein is discussed below in Description of Services, and within Item 8 of this Annual Report on Form 10-K under Note 10 of Notes to Consolidated Financial Statements for the year ended December 31, 2006.

(c) Description of Services

General
We provide management, administrative and operating expertise and services to the housekeeping, laundry, linen, facility maintenance and food service departments of the health care industry.

We are organized into, and provide our services through 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.

Both segments 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.

Our labor force is interchangeable with respect to each of the services within Housekeeping. Our labor force with respect to Food is specific to it. There are many similarities in the nature of the services performed by each segment. However, there are some significant differences in the specialized expertise required of the professional management personnel responsible for delivering the services of the respective segments. We believe the services of each segment provide opportunity for growth.

For the year ended December 31, 2006, GGNSC Holdings LLC (doing business as Golden Horizons), our major client, accounted for 18% of our total revenues. In 2006, we derived 16% and 26% of Housekeeping and Food revenues, respectively, from such client. At December 31, 2006, amounts due from such client represented less than 1% of our accounts receivable balance. 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 existed prior to the merger. Although we expect to continue the relationship with this client, there can be no assurance thereof. The loss of such client, or a significant reduction in the revenues we receive from this client, would have a material adverse effect on the results of operations of our two operating segments. In addition, if such client 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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An overview of each of our segments follows:

Housekeeping

Housekeeping services. Housekeeping services is our largest service sector, representing approximately 57% or $293,374,000 of consolidated revenues in 2006. This service involves cleaning, disinfecting and sanitizing resident areas in our clients facilities. In providing services to any given client facility, we typically hire and train the hourly employees employed by such facility prior to our engagement. We normally assign two on-site managers to each facility to supervise and train hourly personnel and coordinate housekeeping services with other facility support functions. Such management personnel also oversee the execution of a variety of quality and cost-control procedures including continuous training and employee evaluation and on-site testing for infection control. The on-site management team also assists the facility in complying with Federal, state and local regulations.

Laundry and linen services. Laundry and linen services represents approximately 23% or $116,254,000 of consolidated revenues in 2006. Laundry services involve the laundering and processing of the residents personal clothing. We provide laundry service to all of our housekeeping clients. Linen services involve providing, laundering and processing of the sheets, pillow cases, blankets, towels, uniforms and assorted linen items used by our clients facilities. At some facilities that utilize our laundry and linen services, we install our own equipment. Such installation generally requires an initial capital outlay by us ranging from $5,000 to $150,000 depending on the size of the facility, installation and construction costs, and the amount of equipment required. We could incur relocation or other costs in the event of the cancellation of a linen service agreement where there was an investment by us in a corresponding laundry installation. The hiring, training and supervision of the hourly employees who perform laundry and linen services are similar to, and performed by the same management personnel who oversee the housekeeping services hourly employees located at the respective client facility.

In some instances we own linen supplies utilized at our clients facilities. We maintain a sufficient inventory of linen supplies to ensure their availability. We provide linen supplies to approximately 20% of the facilities for which we provide housekeeping services.

Maintenance and other services. Maintenance services consist of repair and maintenance of laundry equipment, plumbing and electrical systems, as well as carpentry and painting. This service sector s total revenues represent less than 1% of consolidated revenues.

Laundry installation sales. We (as a distributor of laundry equipment) sell laundry installations to our clients which generally represent the construction and installation of a turn-key operation. We generally offer payment terms, ranging from 36 to 60 months. During the years 2004 through 2006, laundry installation sales were not material to our operating results as we prefer to own such laundry installations in connection with performance of our service agreements.

Food

Food services. We began providing food services in 1997. Food services represented 19% or $99,513,000 of consolidated revenues in 2006. Food services consist of the development of a menu that meets the residents dietary needs, purchasing and preparing the food to assure that residents receive an appetizing meal, and participation in monitoring the residents on-going nutritional status. On-site management is responsible for all daily food service activities, with regular support being provided by a district manager specializing in food service, as well as a registered dietitian. We also provide consulting services to facilities to assist them in cost containment and improve their food service operations.

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Operational Management Structure

By applying our professional management techniques, we generally can contain or control certain housekeeping, laundry, linen, facility maintenance and food service costs on a continuing basis. We manage and provide our services through a network of management personnel, as illustrated below.

Each facility is managed by an on-site Facility Manager, an Assistant Facility Manager, and if necessary, additional supervisory personnel. Districts, typically consisting of eight to twelve facilities, are supported by a District Manager and a Training Manager. District Managers bear overall responsibility for the facilities within their districts. They are generally based in close proximity to each facility. These managers provide active support to clients in addition to the support provided by our on-site management team. Training Managers are responsible for the recruitment, training and development of Facility Managers. A division consists of a number of regions within a specific geographical area. Divisional Vice Presidents manage each division. At December 31, 2006 we maintained 41 regions within six divisions. Each region is headed by a Regional Vice President/Manager. Some regions also have a Regional Director who assumes primary responsibility for marketing our services within the respective region. Regional Vice Presidents/Managers and Regional Directors provide management support to a number of districts within a specific geographical area. Regional Vice Presidents/Managers and Regional Directors report to Divisional Vice Presidents who in turn report to the President/Chief Operating Officer and Senior Vice Presidents. We believe that our divisional, regional and district organizational structure facilitates our ability to obtain new clients, and our ability to sell additional services to existing clients.

Market

The market for our services consists of a large number of facilities involved in various aspects of the health care industry, including nursing homes, retirement complexes, rehabilitation centers and hospitals. Such facilities may be specialized or general, privately owned or public, profit or not-for-profit, and may serve patients on a long-term or short-term basis. The market for our services is expected to continue to grow as the elderly population increases as a percentage of the United States population and as government reimbursement policies require increased cost control or containment by the constituents that comprise our targeted market.

The American Health Care Association estimates that there are approximately 16,300 nursing homes in the United States with about 1.78 million beds and 1.45 million residents. The facilities primarily range in size from small private facilities with 65 beds to facilities with over 500 beds. We generally market our services to facilities with 100 or more beds. We believe that approximately 15% of our target market, long-term care facilities, currently use outside providers of housekeeping and laundry services.

Marketing and Sales

Our services are marketed at four levels of our organization: at the corporate level by the Chief Executive Officer, President/Chief Operating Officer and the Senior Vice Presidents; at the divisional level by Divisional Vice Presidents; at the regional level by the Regional Vice Presidents/Managers and Regional Directors; and at the district level by District Managers. We provide incentive compensation to our operational personnel based on achieving budgeted earnings and to our Regional Directors based on achieving budgeted earnings and new business revenues.

Our services are marketed primarily through referrals and in-person solicitation of target facilities. We also utilize direct mail campaigns and participate in industry trade shows, health care trade associations and healthcare support services seminars that are offered in conjunction with state or local health authorities in many of the states in which we conduct our business. Our programs have been approved for continuing education credits by state nursing home licensing boards in certain states, and are typically attended by facility owners, administrators and supervisory personnel, thus presenting marketing opportunities for us. Indications of interest in our services arising from initial marketing efforts are followed up with a presentation regarding our services and a survey of the service requirements of the facility. Thereafter, a formal proposal, including operational recommendations and recommendations for proposed savings, is submitted to the prospective client. Once the prospective client accepts the proposal and signs the service agreement, we can set up our operations on-site within days.

Government Regulation of Clients

Our clients are subject to government regulation. Congress has enacted a number of major laws during the past decade that have significantly altered government reimbursement for nursing home services, including the Balanced Budget Act of 1997 (BBA), the Benefits Improvement and Protection Act of 2000 (BIPA), and the Deficit Reduction Act of 2005 (DRA).

As a result of the BBA s repeal of the Boren Amendment federal payment standard for Medicaid payments to nursing facilities, there is ongoing risk that budget constraints or other factors will cause states to reduce Medicaid reimbursements to nursing homes or fail to make payments to nursing homes on a timely basis. BIPA enacted a multi-year phase-out of certain governmental transfers that had boosted Medicaid payment rates, and these reduced federal payments have impacted the aggregate available funds.

The DRA s stated goal of reducing federal Medicaid spending by $6.9 billion over the next five years has financial implications for nursing homes, as do the incentives it put in place for the use of community-based services, since increased use of home and community-based services and the corollary rebalancing of long term care funding towards a more non-institutional approach will likely put downward pressure on nursing home rate increases. In addition, changes to Medicaid asset transfer rules made in the DRA could exacerbate the nursing home Medicaid under-funding problem by increasing the incidence of uncompensated care. Most recently, there is significant federal pressure to reduce the maximum provider tax that states have been increasingly relying on to fund nursing home reimbursement.

Although all of these laws directly affect how clients are paid for certain services, we do not directly participate in any government reimbursement programs. Accordingly, all of our contractual relationships with our clients continue to determine the clients payment obligations to us. However, because clients revenues are generally highly reliant on Medicare and Medicaid reimbursement funding rates, the overall effect of these laws and trends in the long term care industry have affected and could adversely affect the liquidity of our clients, resulting in their inability to make payments to us on agreed upon payment terms. (See Liquidity and Capital Resources).

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The prospects for legislative action, both on the Federal and State level, regarding funding for nursing homes are uncertain. We are unable to predict or to estimate the ultimate impact of any further changes in reimbursement programs affecting our clients future results of operations and/or their impact on our cash flows and operations.

Service Agreements/Collections

We provide our services primarily pursuant to full service agreements with our clients. In such agreements, we are responsible for our management and hourly employees located at clients facilities. We provide services on the basis of a management agreement for a very limited number of clients. In such agreements, our services are comprised of providing on-site management personnel, while the hourly and staff personnel remain employees of the respective client.

We typically adopt and follow the client s employee wage structure, including its policy of wage rate increases, and pass through to the client any labor cost increases associated with wage rate adjustments. Under a management agreement, we provide management and supervisory services while the client facility retains payroll responsibility for its hourly employees. Substantially all of our agreements are full service agreements. These agreements typically provide for a one year term, cancelable by either party upon 30 to 90 days notice after the initial 90-day period. As of December 31, 2006, we provided services to approximately 1,950 client facilities.

Although the service agreements are cancelable on short notice, we have historically had a favorable client retention rate and expect to continue to maintain satisfactory relationships with our clients. The risk associated with short-term service agreements have not materially affected either our linen and laundry services, which may from time-to-time require a capital investment, or our laundry installation sales, which may require us to finance the sales price. Such risks are often mitigated by certain provisions set forth in the agreements entered into with our clients.

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 $622,000, $1,425,000 and $3,700,000 in the years ended December 31, 2006, 2005 and 2004, respectively (See Schedule II-Valuation and Qualifying Accounts, for year-end balances). These provisions represent .1%, .3% and .8%, as a percentage of total revenues, for the years ended December 31, 2006, 2005 and 2004, respectively. 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 our credit risk exposure, our clients could be adversely affected if future industry trends, as discussed in Government Regulation of Clients and Risk Factors , 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 consolidated results of operations and financial condition.

Competition

We compete primarily with the in-house support service departments of our potential clients. Most healthcare facilities perform their own support service functions without relying upon outside management firms. In addition, a number of local firms compete with us in the regional markets in which we conduct business. Several national service firms are larger and have greater financial and marketing resources than us, although historically, such firms have concentrated their marketing efforts on hospitals rather than the long-term care facilities typically serviced by us. Although the competition to provide service to health care facilities is strong, we believe that we compete effectively for new agreements, as well as renewals of existing agreements,

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based upon the quality and dependability of our services and the cost savings we believe we can usually implement for existing and new clients.

Employees

At December 31, 2006, we employed approximately 4,200 management, office support and supervisory personnel. Of these employees, 350 held executive, regional/district management and office support positions, and 3,850 of these employees were on-site management personnel. On such date, we employed approximately 19,400 hourly employees. Many of our hourly employees were previously support employees of our clients. We manage, for a limited number of our client facilities, the hourly employees who remain employed by those clients.

Approximately 12% of our hourly employees are unionized. The majority of these employees are subject to collective bargaining agreements that are negotiated by individual client facilities and are assented to by us, so as to bind us as an employer under the agreements. We may be adversely affected by relations between our client facilities and the employee unions. We are also a direct party to negotiated collective bargaining agreements covering a limited number of employees at a few facilities serviced by us. We believe our employee relations are satisfactory.

(d) Financial Information About Geographic Areas

Our Housekeeping segment provides services in Canada, although essentially all of its revenues and net income, 99% in each category, are earned in one geographic area, the United States. The Food segment only provides services in the United States.

(e) Available Information

Healthcare Services Group, Inc. is a reporting company under the Securities Exchange Act of 1934, as amended, and files reports, proxy statements and other information with the Securities and Exchange Commission (the Commission or SEC). The public may read and copy any of our filings at the Commissioner s Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330. Additionally, because we make filings to the Commission electronically, you may access this information at the Commission s internet site: www.sec.gov. This site contains reports, proxies and information statements and other information regarding issuers that file electronically with the Commission.

Website Access

Our website address is www.hcsgcorp.com. Our filings with the Commission, as well as other pertinent financial and Company information are available at no cost on our website as soon as reasonably practicable after the filing of such reports with the Commission.

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Item 1A. Risk Factors.

We make forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, in this report and documents incorporated by reference into this report, other public filings with the Securities and Exchange Commission, and in our press releases. Such forward-looking statements are not historical facts but rather are based on current expectations, estimates and projections about our business and industry, our beliefs and assumptions. Generally they may include statements on; projections of revenues, net income, earnings per share, cash flows and other financial data. Additionally, we may make forward-looking statements relating to business objectives of management and evaluations of the market we serve. Such forward-looking statements are subject to risks and uncertainties that could cause actual results or objectives to differ materially from those projected. The inclusion of forward-looking statements should not be regarded as a representation by us that any of our plans will be achieved. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

We have described below what we believe are our most significant risk factors, which may be beyond our control and could cause results to differ significantly from our projections.

We have one client, a nursing home chain, which due to its significant contribution to our total revenues, we consider a major client.

Golden Horizons, our major client accounted for 18% of our 2006 total consolidated revenues, consisting of 16% and 26% of our Housekeeping and Food revenues, respectively. At December 31, 2006, amounts due from such client represented less than 1% of our accounts receivable balance. 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 existed prior to the merger. Although we expect to continue the relationship with this client, there can be no assurance thereof. The loss of such client, or a significant reduction in the revenues we receive from such client, would have a material adverse effect on the results of operations of our two operating segments. In addition, if such client 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.

Although we expect that the acquisition of Summit will result in benefits to our company, those benefits may not occur, or may be delayed, because of integration and other challenges associated with the acquisition.

On September 18, 2006, effective as of August 31, 2006, we acquired Summit. Achieving the benefits we expect from the acquisition of Summit depends in part on our ability to integrate Summit s and our operations and personnel in a timely and efficient manner. Although much of this integration has already occurred, there remain aspects of the integration, known and unknown, which will take time to fully accomplish. Such integration challenges include, but are not limited to:

- potential loss of key employees and management.
- integration of acquired personnel into our culture and philosophies.
- diversion of management focus and attention.
- assumption of liabilities and potentially unknown liabilities including past failures to comply with healthcare or other authorities regulations.
- potential loss of clients acquired through the acquisition due to changes in management of Summit or if our operations do not meet the financial or service expectations of such clients.

Our clients are concentrated in the health care industry.

We provide our services primarily to providers of long-term care. Congress has enacted a number of major laws during the past decade that have significantly altered, or may alter, overall government reimbursement for nursing home services. Because our clients revenues are generally highly reliant on Medicare and Medicaid reimbursement funding rates and mechanisms, the overall effect of these laws and trends in the long term care industry have affected and could adversely affect the liquidity of our clients, resulting in their inability to make payments to us on agreed upon payment terms. 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 future.

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

We provide services in 47 states and are subject to numerous local taxing jurisdictions within those states.
The taxability of our services is subject to various interpretations within the taxing jurisdictions of our markets. Consequently, 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. A jurisdiction s conflicting position on the taxability of our services could result in additional tax liabilities which we may not be able to pass on to our clients or could negatively impact our competitive position in the respective location. Additionally, if we or one of our employees fail to comply with applicable tax laws and regulations we could suffer civil or criminal penalties in addition to the delinquent tax assessment.

We primarily provide our services pursuant to agreements which have a one year term, cancelable by either party upon 30 to 90 days notice after the initial 90-day service agreement period.
We do not enter into long-term contractual agreements with our clients for the rendering of our services. Consequently, our clients can unilaterally decrease the amount of services we provide or terminate all services pursuant to the terms of our service agreements. Any loss of a significant number of clients during the first year of providing services, for which we have incurred significant start-up costs or invested in an equipment installation, could in the aggregate materially adversely affect our consolidated results of operations and financial position.

We are dependent on the management experience of our key personnel.
We manage and provide our services through a network of management personnel, from the on-site facility manager up to the executive officers of the company. Therefore, we believe that our ability to recruit and sustain the internal development of managerial personnel is an important factor impacting future operating results and our ability to successfully execute projected growth strategies. Our professional management personnel are the key personnel in maintaining and selling additional services to current clients and obtaining new clients.

We may in general be adversely affected by inflationary or market fluctuations in the cost of products consumed in providing our services or our cost of labor
The prices we pay for the principal items we consume in performing our services are dependent primarily on current market prices. Additionally, our cost of labor may be influenced by unanticipated factors in certain market areas or increases in collective bargaining agreements of our clients, to which we assent. Although we endeavor to pass on such increased costs to our clients, any inability or delay in passing on such increases in costs could negatively impact our profitability.

Market expectations are high and rely greatly on execution of our growth strategy and related increases in financial performance.
Management believes the historical price increases of our Common Stock reflect high market expectations for our future operating results. In particular, our ability to attract new clients, through organic growth or

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acquisitions, has enabled us to execute our growth strategy and increase market share. If, in the event we are not able to continue historical client and revenue growth rates, our operating performance may be adversely affected. Any failure to meet the market s high expectations for our revenue and operating results may trigger our Common Stock price to decline.

Item 1B. Unresolved Staff Comments.
Not applicable.

Item 2. Properties.
We lease our corporate offices, located at 3220 Tillman Drive, Suite 300, Bensalem, Pennsylvania 19020. We also lease office space at other locations in Pennsylvania, Connecticut, Massachusetts, Florida, Illinois, California, Colorado, Georgia, and New Jersey. These locations serve as divisional or regional offices providing management and administrative services to both of our operating segments in their respective geographical areas.

We lease warehouse space in Bristol, Pennsylvania accommodating the operations of HCSG Supply, Inc. Supplies and equipment warehoused and distributed out of this location are used by both operating segments in providing their respective services.

We are also provided with office and storage space at each of our client facilities.

Management does not foresee any difficulties with regard to the continued utilization of all of the aforementioned premises. We also believe that such properties are sufficient for our current operations.

We presently own laundry equipment, office furniture and equipment, housekeeping equipment and vehicles. Such office furniture and equipment, and vehicles are primarily located at our corporate office, warehouse, and divisional and regional offices. We have housekeeping equipment at all client facilities where we provide services under a full service housekeeping agreement. Generally, the aggregate cost of housekeeping equipment located at each client facility is less than $2,500. Additionally, we have laundry installations at approximately 125 client facilities. Our cost of such laundry installations ranges between $5,000 and $150,000. We believe that such laundry equipment, office furniture and equipment, housekeeping equipment and vehicles are sufficient for our current operations.

Item 3. Legal Proceedings.
As of December 31, 2006, there were no material pending legal proceedings to which we were a party, or as to which any of our property was subject, other than routine litigation or claims and/or proceedings believed to be adequately covered by insurance.

Item 4. Submission of Matters to a Vote of Security Holders.
Not applicable.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

(a) Market Information

Our common stock, $.01 par value (the Common Stock), is traded under the symbol HCSG on the NASDAQ Global Select Market. On February 14, 2007, there were 27,600,000 shares of Common Stock outstanding and held by non-affiliates.

The high and low sales price quotations for our Common Stock during the years ended December 31, 2006 and 2005 ranged as follows (adjusted, where applicable, to reflect the 3 for 2 stock split in the form of a 50% common stock dividend on May 2, 2005):

	2006 High	2006 Low
1st Qtr.	$21.60	$18.21
2nd Qtr.	$22.52	$19.02
3rd Qtr.	$25.53	$19.29
4th Qtr.	$29.14	$24.77

	2005 High	2005 Low
1st Qtr.	$16.53	$12.54
2nd Qtr.	$20.65	$14.17
3rd Qtr.	$21.60	$15.77
4th Qtr.	$21.45	$17.01

(b) Holders

We have been advised by our transfer agent, American Stock Transfer and Trust Company, that we had 680 holders of record of our Common Stock as of February 20, 2007. Based on reports of security position listings compiled for the 2006 annual meeting of shareholders, we believe we may have approximately 3,500 beneficial owners of our Common Stock.

(c) Dividends

We have paid regular quarterly cash dividends since the second quarter of 2003. During 2006, we paid regular quarterly cash dividends totaling $12,627,000.

A summary of such 2006 cash dividend payments follows:

	Cash Dividend	Payment Date	Record Date
1st Quarter	$.10	February 13	February 3
2nd Quarter	$.11	May 10	April 28
3rd Quarter	$.12	August 11	July 28
4th Quarter	$.13	November 10	October 27

Additionally, on January 23, 2007, our Board of Directors declared a regular quarterly cash dividend of $.14 per common share, which was paid on February 14, 2007 to shareholders of record as of February 5, 2007.

On April 19, 2005, our Board of Directors approved a three-for-two stock split in the form of a 50% common stock dividend which was paid on May 2, 2005 to shareholders of record on April 29, 2005.

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 as to 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.

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(d) Securities Authorized for Issuance Under Equity Compensation Plans

The following table sets forth for the Company s equity compensation plans, on an aggregated basis, the number of shares of its Common Stock subject to outstanding options, the weighted-average exercise price of outstanding options, and the number of shares remaining available for future award grants as of December 31, 2006.

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	2,433,000[1]	$8.70	3,419,000[2]
Equity compensation plans not approved by security holders	N/A	N/A	N/A
Total	2,433,000	$8.70	3,419,000

1 Represents shares of Common Stock issuable upon exercise of outstanding options granted under either the 2002 Plan, the 1996 Plan, or the 1995 Incentive and Non-qualified Stock Option Plan (the Stock Option Plans).

2 Includes options to purchase 1,809,000 shares available for future grant under the Company s Stock Option Plans. Also includes 1,335,000 and 275,000 shares available for issuance under the Company s 1999 Employee Stock Purchase Plan and 1999 Deferred Compensation Plan, respectively (collectively, the 1999 Plans). Treasury shares may be issued under the 1999 Plans.

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(e) Performance Graph

Comparison of 5 Year Cumulative Total Return*
Among Healthcare Services Group, Inc., The S & P 500 Index
And The S & P Health Care Distributors Index

* $100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

Recent sales of Unregistered Securities

None

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None

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Item 6. Selected Financial Data.

The following selected condensed consolidated financial data has been derived from, and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our Consolidated Financial Statements and Notes thereto, included elsewhere in this report on Form 10-K and incorporated herein by reference.

	(in thousands except for per share data)				
Years Ended December 31:	2006	2005	2004	2003	2002
Selected Operating Results:					
Total revenue	$ 511,631	$ 466,291	$ 442,568	$ 379,718	$ 328,500
Net income	$ 25,452	$ 19,096	$ 14,699	$ 10,860	$ 8,631
Basic earnings per Common Share	$ .93	$ .71	$ .56	$ .42	$ .34
Diluted earnings per Common Share	$ .89	$ .67	$ .53	$ .41	$ .33
Selected Balance Sheet Data:					
Total assets	$ 215,556	$ 188,430	$ 166,964	$ 158,328	$ 134,296
Stockholders equity	$ 165,477	$ 148,163	$ 131,460	$ 121,198	$ 107,881
Selected Other Financial Data:					
Working capital	$ 140,627	$ 142,535	$ 125,012		