

HEALTHCARE SERVICES GROUP INC

Form 10-Q

April 23, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended March 31, 2007

Commission File Number 0-120152

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

Pennsylvania

23-2018365

(State or other jurisdiction of
incorporation or organization)

(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 in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer Accelerated filer Non-accelerated filer

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

Number of shares of common stock, issued and outstanding as of April 20, 2007 is 27,725,000

Total of 36 Pages

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PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

Consolidated Balance Sheets

| | (Unaudited) March 31, 2007 | December 31, 2006 |
|--|----------------------------------|-----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 78,999,000 | \$ 72,997,000 |
| Accounts and notes receivable, less allowance for doubtful accounts of \$4,612,000 in 2007 and \$2,716,000 in 2006 | 80,691,000 | 78,086,000 |
| Inventories and supplies | 13,162,000 | 12,640,000 |
| Deferred income taxes | 1,204,000 | 652,000 |
| Prepaid expenses and other | 4,192,000 | 3,862,000 |
| Total current assets | 178,248,000 | 168,237,000 |
| PROPERTY AND EQUIPMENT: | | |
| Laundry and linen equipment installations | 1,748,000 | 1,781,000 |
| Housekeeping equipment and office equipment | 16,223,000 | 16,086,000 |
| Autos and trucks | 85,000 | 85,000 |
| | 18,056,000 | 17,952,000 |
| Less accumulated depreciation | 13,308,000 | 13,077,000 |
| | 4,748,000 | 4,875,000 |
| GOODWILL, Less accumulated amortization of \$1,743,000 in 2007 and 2006 | 14,570,000 | 14,543,000 |
| OTHER INTANGIBLE ASSETS, Less accumulated amortization of \$617,000 in 2007 and \$352,000 in 2006 | 6,883,000 | 7,148,000 |
| NOTES RECEIVABLE- long term portion, net of discount | 8,082,000 | 7,861,000 |
| DEFERRED COMPENSATION FUNDING | 8,356,000 | 7,385,000 |
| DEFERRED INCOME TAXES- long term portion | 5,739,000 | 5,403,000 |
| OTHER NONCURRENT ASSETS | 105,000 | 104,000 |
| TOTAL ASSETS | \$ 226,731,000 | \$ 215,556,000 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 7,474,000 | \$ 10,139,000 |
| Accrued payroll, accrued and withheld payroll taxes | 15,594,000 | 10,125,000 |
| Other accrued expenses | 2,171,000 | 2,425,000 |
| Income taxes payable | 192,000 | 274,000 |
| Accrued insurance claims | 4,623,000 | 4,647,000 |
| Total current liabilities | 30,054,000 | 27,610,000 |
| ACCRUED INSURANCE CLAIMS- long term portion | 10,786,000 | 10,843,000 |
| DEFERRED COMPENSATION LIABILITY | 12,497,000 | 11,626,000 |

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS EQUITY:

| | | |
|---|----------------|----------------|
| Common stock, \$.01 par value: 30,000,000 shares authorized, 29,172,000 shares issued in 2007 and 28,999,000 shares in 2006 | 292,000 | 290,000 |
| Additional paid in capital | 62,565,000 | 58,809,000 |
| Retained earnings | 127,831,000 | 124,268,000 |
| Common stock in treasury, at cost, 1,458,000 shares in 2007 and 1,517,000 shares in 2006 | (17,294,000) | (17,890,000) |
| Total stockholders equity | 173,394,000 | 165,477,000 |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 226,731,000 | \$ 215,556,000 |

See accompanying notes.

Table of Contents**Consolidated Statements of Income
(Unaudited)**

| | For the Three Months Ended March 31, | |
|--|---|----------------|
| | 2007 | 2006 |
| Revenues | \$ 140,679,000 | \$ 118,918,000 |
| Operating costs and expenses: | | |
| Costs of services provided | 119,314,000 | 102,182,000 |
| Selling, general and administrative | 10,511,000 | 9,074,000 |
| Other Income : | | |
| Investment and interest income | 1,261,000 | 1,347,000 |
| | | |
| Income before income taxes | 12,115,000 | 9,009,000 |
| | | |
| Income taxes | 4,665,000 | 3,333,000 |
| | | |
| Net Income | \$ 7,450,000 | \$ 5,676,000 |
| | | |
| Basic earnings per common share | \$ 0.27 | \$ 0.21 |
| | | |
| Diluted earnings per common share | \$ 0.26 | \$ 0.20 |
| | | |
| Cash dividends per common share | \$ 0.14 | \$ 0.10 |
| | | |
| Basic weighted average number of common shares outstanding | 27,771,000 | 27,320,000 |
| | | |
| Diluted weighted average number of common shares outstanding | 29,108,000 | 28,620,000 |

See accompanying notes.

Table of Contents**Consolidated Statements of Cash Flows**

| | (Unaudited) | |
|---|----------------------------|--------------|
| | For the Three Months Ended | |
| | March 31, | |
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net Income | \$ 7,450,000 | \$ 5,676,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 745,000 | 473,000 |
| Bad debt provision | 1,977,000 | 375,000 |
| Deferred income taxes benefits | (888,000) | (386,000) |
| Stock-based compensation expense | 103,000 | 81,000 |
| Tax benefit of stock option transactions | | 513,000 |
| Unrealized gain on deferred compensation fund investments | (382,000) | (434,000) |
| Changes in operating assets and liabilities: | | |
| Accounts and notes receivable | (4,582,000) | (3,955,000) |
| Inventories and supplies | (522,000) | (220,000) |
| Notes receivable- long term portion | (221,000) | 226,000 |
| Deferred compensation funding | (589,000) | (91,000) |
| Accounts payable and other accrued expenses | (2,541,000) | 416,000 |
| Accrued payroll, accrued and withheld payroll taxes | 6,242,000 | 5,493,000 |
| Accrued insurance claims | (81,000) | 135,000 |
| Deferred compensation liability | 871,000 | 885,000 |
| Income taxes payable | (82,000) | 434,000 |
| Prepaid expenses and other assets | (330,000) | (613,000) |
| Net cash provided by operating activities | 7,170,000 | 9,008,000 |
| Cash flows from investing activities: | | |
| Disposals of fixed assets | 61,000 | 32,000 |
| Additions to property and equipment | (415,000) | |
| Cash paid for acquisition | (27,000) | (487,000) |
| Net cash used in investing activities | (381,000) | (455,000) |
| Cash flows from financing activities: | | |
| Treasury stock transactions in benefit plans | 82,000 | (37,000) |
| Dividends paid | (3,887,000) | (2,730,000) |
| Reissuance of treasury stock pursuant to Dividend Reinvestment Plan | 14,000 | 9,000 |
| Tax benefit from equity compensation plans | 1,307,000 | |
| Proceeds from the exercise of stock options | 1,697,000 | 1,209,000 |
| Net cash used in financing activities | (787,000) | (1,549,000) |
| Net increase in cash and cash equivalents | 6,002,000 | 7,004,000 |

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| | | |
|---|---------------|---------------|
| Cash and cash equivalents at beginning of the period | 72,997,000 | 91,005,000 |
| Cash and cash equivalents at end of the period | \$ 78,999,000 | \$ 98,009,000 |
| Supplementary Cash Flow Information: | | |
| Income taxes cash payments, net of refunds | \$ 4,328,000 | \$ 2,771,000 |
| Issuance of 43,000 shares of Common Stock in 2007 and 64,000 shares of Common Stock in 2006 pursuant to Employee Stock Plans | \$ 1,254,000 | \$ 728,000 |

See accompanying notes.

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Table of ContentsConsolidated Statements of Stockholders' Equity
(Unaudited)For the Three Months Ended March 31, 2007

| | Common Stock Shares | Common Stock Amount | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Stockholders' Equity |
|---|------------------------|------------------------|----------------------------------|----------------------|-------------------|-------------------------|
| Balance, December 31, 2006 | 28,999,000 | \$ 290,000 | \$ 58,809,000 | \$ 124,268,000 | (\$17,890,000) | \$ 165,477,000 |
| Net income for the period | | | | 7,450,000 | | 7,450,000 |
| Exercise of stock options and other share-based compensation, net of 4,000 shares tendered for payment | 173,000 | 2,000 | 1,695,000 | | | 1,697,000 |
| Tax benefit arising from stock option transactions | | | 1,307,000 | | | 1,307,000 |
| Shares purchased and shares sold in employee Deferred Compensation Plan and other benefit plans (15,000 shares) | | | | | 82,000 | 82,000 |
| Shares issued pursuant to Employee Stock Plans (43,000 shares) | | | 745,000 | | 509,000 | 1,254,000 |
| Cash dividends \$.14 per common share | | | | (3,887,000) | | (3,887,000) |
| Shares issued pursuant to Dividend Reinvestment Plan (1,000 shares) | | | 9,000 | | 5,000 | 14,000 |
| Balance, March 31, 2007 | 29,172,000 | \$ 292,000 | \$ 62,565,000 | \$ 127,831,000 | (\$17,294,000) | \$ 173,394,000 |

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, 2006 has been derived from, and does not include, all the disclosures contained in the financial statements for the year ended December 31, 2006. 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, 2006. The results of operations for the quarter ended March 31, 2007 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 - Acquisition

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. In conjunction with the acquisition, the aggregate consideration to the Summit shareholders was comprised of a cash payment of approximately \$9,460,000 and the issuing of approximately 369,000 shares of our common stock to such selling shareholders of Summit (valued at approximately \$8,516,000). Additionally as of March 31, 2007, we have incurred total transactions costs of approximately \$303,000 (including \$27,000 in the 2007 first quarter), consisting primarily of accounting and legal fees.

As noted, the Summit acquisition is being accounted for under the purchase method of accounting. The acquisition was not considered a material transaction. Accordingly, supplemental pro forma information reflecting the acquisition of Summit as if it occurred on January 1, 2006 has not been provided. Furthermore, our results of operations at March 31, 2006 included in this report do not include Summit s operations . Additionally, effective January 1, 2007, Summit s operations were fully integrated into our operations.

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Table of Contents**Note 3 - Goodwill and Other Intangible Assets**

We apply the provisions of SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets in accounting for our goodwill and other identifiable intangible assets. SFAS No. 141 addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination, whether acquired individually or with a group of other assets, and the accounting and reporting for goodwill and other intangible assets subsequent to their acquisition.

The following table sets forth the amounts of our identifiable intangible assets subject to amortization, which were acquired in the Summit acquisition, and the amortization expense recognized thereon for the 2007 first quarter:

| | Acquisition Amount | Amortization Expense |
|------------------------|-----------------------|-------------------------|
| Customer Relationships | \$ 6,700,000 | \$ 239,000 |
| Non-compete Agreements | 800,000 | 25,000 |
| Total | \$ 7,500,000 | \$ 264,000 |

The customer relationships have a weighted-average amortization period of seven years and the non-compete agreements have a weighted-average amortization period of eight years. The following table sets forth the estimated amortization expense for intangibles subject to amortization for the remaining nine months in our 2007 fiscal year and following four fiscal years:

| Period/Year | Customer Relationships | Non-Compete Agreements | Total |
|------------------------------|---------------------------|---------------------------|-------------|
| April 1 to December 31, 2007 | \$718,000 | \$ 75,000 | \$ 793,000 |
| 2008 | \$957,000 | \$100,000 | \$1,057,000 |
| 2009 | \$957,000 | \$100,000 | \$1,057,000 |
| 2010 | \$957,000 | \$100,000 | \$1,057,000 |
| 2011 | \$957,000 | \$100,000 | \$1,057,000 |

The following table sets forth the amount of goodwill as March 31, 2007 which is subject to impairment testing, rather than amortization and the adjustments, if any, to the amounts of such goodwill during the three months ended March 31, 2007.

| | Summit | All other | Total |
|--|---------------|--------------|---------------|
| Goodwill as of December 31, 2006 | \$ 12,931,000 | \$ 1,612,000 | \$ 14,543,000 |
| Goodwill adjustments during first quarter(1) | 27,000 | | 27,000 |
| Goodwill as of March 31, 2007 | \$ 12,958,000 | \$ 1,612,000 | \$ 14,570,000 |

(1) Goodwill adjusted during the quarter relates to professional fees expense incurred.

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The following table sets forth by reportable business segment, as described in Note 5 herein, the amounts of goodwill:

| Segment | Amount |
|--------------|---------------|
| Food | \$ 1,351,000 |
| Housekeeping | 13,219,000 |
| Total | \$ 14,570,000 |

Note 4- Other Contingencies

We have a \$30,000,000 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 March 31, 2007, there were no borrowings under the line of credit. However, at such date, we had outstanding a \$27,725,000 irrevocable standby letter of credit which relates 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 \$27,725,000 at March 31, 2007. The line of credit requires us to satisfy two financial covenants. We are in compliance with the financial covenants at March 31, 2007 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 47 states and we are subject to numerous local taxing jurisdictions within those states. Consequently, the taxability of our 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 March 31, 2007 and December 31, 2006 we had unsettled tax assessments from a state taxing authority of \$580,000 (\$363,000, net of federal income taxes). With respect to these assessments, we recorded a reserve at both March 31, 2007 and December 31, 2006 of \$320,000 (\$175,000 net of federal income taxes).

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 based on our best estimate of the outcomes of such matters.

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 affect on our financial position or consolidated results of operations.

Congress has enacted a number of major laws during the past decade that have significantly altered, or threaten to 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

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

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 | Food | Corporate and Eliminations | Total |
|------------------------------|----------------|---------------|-------------------------------|----------------|
| Quarter Ended March 31, 2007 | | | | |
| Revenues | \$ 113,201,000 | \$ 26,553,000 | \$ 925,000 | \$ 140,679,000 |
| Income before income taxes | \$ 11,320,000 | \$ 1,181,000 | \$ (386,000)(1) | \$ 12,115,000 |
| Quarter Ended March 31, 2006 | | | | |
| Revenues | \$ 94,859,000 | \$ 23,039,000 | \$ 1,020,000 | \$ 118,918,000 |
| Income before income taxes | \$ 9,414,000 | \$ 703,000 | \$ (1,108,000)(1) | \$ 9,009,000 |

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

Table of Contents**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 March 31, | |
|--------------------------------|---------------------------------|----------------|
| | 2007 | 2006 |
| Housekeeping services | \$ 79,529,000 | \$ 67,307,000 |
| Laundry and linen services | 34,212,000 | 28,091,000 |
| Food Services | 26,319,000 | 22,909,000 |
| Maintenance services and Other | 619,000 | 611,000 |
| | \$ 140,679,000 | \$ 118,918,000 |

Major Client

We have one client, a nursing home chain, which in the three month periods ended March 31, 2007 and 2006 accounted for 16% and 19%, respectively, of total revenues. In the three month period ended March 31, 2007, we derived 15% and 22%, respectively, of Housekeeping and Food s revenues from such client. Additionally, at both March 31, 2007 and 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 established 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 revenues 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.

Note 6 - Earnings Per Common Share

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

| | Quarter Ended March 31, 2007 | | |
|-----------------------------------|------------------------------|---------------|-----------|
| | Income | Shares | Per-share |
| | (Numerator) | (Denominator) | Amount |
| Net income | \$ 7,450,000 | | |
| Basic earnings per common share | \$ 7,450,000 | 27,771,000 | \$.27 |
| Effect of dilutive securities: | | | |
| Options | | 1,337,000 | (.01) |
| Diluted earnings per common share | \$ 7,450,000 | 29,108,000 | \$.26 |

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| | Quarter Ended March 31, 2006 | | |
|-----------------------------------|------------------------------|-------------------------|---------------------|
| | Income (Numerator) | Shares (Denominator) | Per-share Amount |
| Net income | \$ 5,676,000 | | |
| Basic earnings per common share | \$ 5,676,000 | 27,320,000 | \$.21 |
| Effect of dilutive securities: | | | |
| Options | | 1,300,000 | (.01) |
| Diluted earnings per common share | \$ 5,676,000 | 28,620,000 | \$.20 |

Options to purchase 426,000 shares of common stock at an average exercise price of \$20.71 were outstanding during the three month period ended March 31, 2006 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 the three month period ended March 31, 2007 as none have an exercise price in excess of the average market value of our common stock during such period.

Note 7 Dividends

On February 14, 2007 we paid, to shareholders of record on February 5, 2007, a regular quarterly cash dividend of \$.14 per common share. Such regular quarterly cash dividend payment in the aggregate was \$3,887,000. Additionally, on April 17, 2007, our Board of Directors declared a regular cash dividend of \$.15 per common share to be paid on May 11, 2007 to shareholders of record as of April 27, 2007.

Note 8 Share-Based Compensation

During the three months ended March 31, 2007, 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 Term (In Years) | Aggregate Intrinsic Value |
|--|------------------------------|---------------------|---|---------------------------------|
| Outstanding, January 1, 2007 | \$ 8.70 | 2,434,000 | | |
| Granted | | | | |
| Cancelled | | | | |
| Exercised | 9.76 | (177,000) | | |
| Outstanding, March 31, 2007 | \$ 8.62 | 2,257,000 | 5.08 | \$ 45,213,000 |
| Options exercisable as of March 31, 2007 | | 2,257,000 | 5.08 | \$ 45,213,000 |

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The following table summarizes information about stock options outstanding at March 31, 2007.

| Exercise Price Range | Options Outstanding | | | Options Exercisable | |
|----------------------|---------------------|------------------------------------|---------------------------------|---------------------|---------------------------------|
| | Number Outstanding | Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$2.25 - 3.75 | 428,000 | 2.73 | \$ 3.04 | 428,000 | \$ 3.04 |
| \$4.11 - 5.62 | 775,000 | 4.94 | 4.66 | 775,000 | 4.66 |
| \$8.29 - 8.29 | 397,000 | 6.74 | 8.29 | 397,000 | 8.29 |
| \$13.65 - 13.65 | 335,000 | 7.74 | 13.65 | 335,000 | 13.65 |
| \$20.71 - 20.71 | 322,000 | 3.75 | 20.71 | 322,000 | 20.71 |
| | 2,257,000 | 5.08 | \$ 8.62 | 2,257,000 | \$ 8.62 |

Other information pertaining to option activity during the three month periods ended March 31, 2007 and March 31, 2006 was as follows:

| | March 31, 2007 | March 31, 2006 |
|--|----------------|----------------|
| Weighted average grant-date fair value of stock options granted: | Not applicable | Not applicable |
| Total fair value of stock options vested: | Not applicable | Not applicable |
| Total intrinsic value of stock options exercised: | \$3,345,000 | \$1,512,000 |

Under our Plans at March 31, 2007, in addition to the 2,257,000 shares issuable pursuant to outstanding option grants, an additional 1,813,000 shares of our Common Stock are available for future grants. Options outstanding and exercisable were granted at stock option prices which were not less than the fair market value of our Common Stock on the date the options were 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 after the option grant date.

The pre-tax share-based employee compensation expense recorded in both the 2007 and 2006 first quarters resulted solely from the estimated value to be recognized from the share-based payments of our Employee Stock Purchase Plan (ESPP). It is estimated, at this time, that the expense attributable to such share-based payments in each of the subsequent quarters of 2007 will approximate the amount recorded in the 2007 first quarter. However, such future expense related to our ESPP will be impacted by and be dependent on the change in our stock price over the remaining period up to the December 31, 2007 measurement date.

The pre-tax amounts expensed and assumptions utilized in estimating the fair market value under the Black-Sholes option pricing model of our ESPP for the 2007 and 2006 first quarters were:

| | 2007 | 2006 |
|---|------------|-----------|
| Pre-tax shared-based compensation expense | \$ 103,000 | \$ 81,000 |
| Risk-free interest rate | 4.9% | 4.0% |
| Expected volatility | 33.9% | 35.0% |
| Weighted average expected life (in years) | .75 | 1.0 |
| Dividend yield | 1.6% | 1.9% |

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We may issue new common stock shares or re-issue common stock shares from treasury to satisfy our obligations under any of our share-based compensation plans.

Note 9 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 three month periods ended March 31, 2007 and March 31, 2006, the service agreements with the client facilities in which the Related Parties have ownership interests resulted in revenues of \$1,280,000 and \$1,932,000, respectively. At March 31, 2007 and December 31, 2006, accounts and notes receivable from such facilities of \$2,658,000 and \$3,027,000, respectively, are included in the accompanying consolidated balance sheets.

Another of our directors is a member of a law firm which was retained by us. During the three month periods ended March 31, 2007 and March 31, 2006, fees received from us by such firm did not exceed \$100,000 in either period. Additionally, such fees did not exceed, in either three month period, 5% of such firm s revenues.

Note 10- Cumulative Effect of Adjustment to Deferred Compensation Liability

At December 31, 2006, a cumulative effect of adjusting our deferred compensation liability resulted from applying the provisions of Securities and Exchange Commission Staff Accounting Bulletin No. 108 (SAB No. 108) . We have adopted SAB No. 108 at December 31, 2006 and for the year then ended. Historically, the appreciation on our Common Stock held in our Deferred Compensation Plan (the Plan) trust account was not recognized in the reporting of the deferred compensation liability. In accordance with the guidance provided by Emerging Issues Task Force Issue No. 97-14 (EITF No. 97-14), in the year ended December 31, 2006, we increased our recorded deferred compensation liability to reflect the current fair market value of our shares held in the Plan trust account. Prior to the adoption of SAB No. 108, we used the rollover method described therein in evaluating the materiality of financial statements adjustments. We determined the impact from the adjustment to be immaterial to 2006 and prior periods financial results under the rollover method. Pursuant to the guidance of SAB No. 108, the adjustment to the liability was accomplished by the recording in 2006 of the cumulative effect, as of January 1, 2006, of a \$1,432,000 (\$856,000 net of income taxes) increase to correct the liability balance as of December 31, 2005, with a corresponding charge to retained earnings 2006 beginning balance. Additionally, the 2006 financial statements were effected by an adjustment of approximately \$970,000 (\$605,000 net of income taxes) to increase the liability with a corresponding charge to deferred compensation expense to reflect the changes in fair market value of our Common Stock held in the Plan trust account during 2006. Of this adjustment, approximately \$183,000 was applicable to and decreased previously reported 2006 first quarter selling, general and administrative expense. Accordingly, this adjustment resulted in decreasing previously reported 2006 first quarter net income by \$115,000, it had no effect on such period s basic or diluted earnings per common share.

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Note 11- Income Taxes

We adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 (FIN 48), on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Based on our evaluation, we have concluded that there are no significant uncertain tax positions requiring recognition in our financial statements. Our evaluation was performed for the tax years ended December 31, 2003, 2004, 2005 and 2006, the tax years which remain subject to examination by major tax jurisdictions as of March 31, 2007.

We may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results. In the event we have received an assessment for interest and/or penalties, it has been classified in the financial statements as selling, general and administrative expense.

Note 12 Recently Issued Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). Among other requirements, SFAS No. 157 defines fair value and establishes a framework for measuring fair value and also expands disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 is effective beginning the first fiscal year that begins after November 15, 2007. We are required to adopt SFAS no. 157 on January 1, 2008. We are currently evaluating the potential impact of this interpretation.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS No. 158)

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159), which permits entities to elect to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. This election is irrevocable. SFAS No. 159 will be effective in the first quarter of fiscal 2008. We are currently assessing the potential impact that the adoption of SFAS No. 159 will have on our financial statements.

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

Cautionary Statement Regarding Forward Looking Statements

This report and documents incorporated by reference into this report contain 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 (the Exchange Act), as amended, are not historical facts but rather based on current expectations, estimates and projections about our business and industry, our beliefs and assumptions. Words such as believes, anticipates, plans, expects, will, goal, and similar expressions are intended to identify forward-looking statements. 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. Such forward looking information is also subject to various risks and uncertainties. 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 16% of revenues in the 2007 first quarter-(see Note 5,

Major Client in the accompanying Notes to Consolidated Financial Statements); risks associated with our acquisition of Summit Services Group, Inc., including integration risks and costs, or such business not achieving expected financial results or synergies or failure to otherwise perform as expected; 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, 2006 in Part I thereof under Government Regulation of Clients, Competition and Service Agreements/Collections, and under Part IA Risk Factors. Many of our clients' revenues are highly contingent on Medicare and Medicaid reimbursement funding rates, which Congress has affected through the enactment of a number of major laws during the past decade. These laws have significantly altered, or threatened to alter, overall government 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 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.

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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 March 31, 2007 and December 31, 2006 and the periods then ended and the notes accompanying those financial statements.

As disclosed in Note 2 of the Notes to the Consolidated Financial Statements, the September 18, 2006 Summit acquisition was effective as of August 31, 2006. Such acquisition is being accounted for under the purchase method of accounting. The acquisition was not considered a material transaction. Accordingly, supplemental pro forma information reflecting the acquisition of Summit as if it occurred on January 1, 2006 has not been provided. Additionally, effective January 1, 2007, Summit's operations were fully integrated into Healthcare. Summit's impact, when quantifiable, are discussed in the following discussion where we believe it would contribute to the reader's understanding of our financial statements.

As disclosed in Note 10 of the Notes to the Consolidated Financial Statements, in 2006 we recorded a cumulative effect of adjusting our deferred compensation liability which resulted from applying the provisions SAB No. 108. Prior to the adoption of SAB No. 108, we used the rollover method described therein in evaluating the materiality of financial statements adjustments. We determined the impact from the adjustment to be immaterial to current and prior periods' financial results under the rollover method. Additionally, we have evaluated the adjustment using the dual approach method described in SAB No. 108. Pursuant to the guidance of SAB No. 108, the adjustment to the liability was accomplished by the recording in 2006 of the cumulative effect, as of January 1, 2006, a \$1,432,000 (\$856,000 net of income taxes) increase to correct the liability balance as of December 31, 2005. Offsetting this increase to our liability was a corresponding charge to retained earnings 2006 beginning balance. Additionally, the 2006 financial statements were effected by the adjustment through an approximately \$970,000 (\$605,000 net of income taxes) increase to the liability with a corresponding charge to deferred compensation expense to reflect the changes in fair market value during 2006. Of this adjustment, approximately \$183,000 (\$115,000 net of income taxes) was applicable to the previously reported three month period ended March 31, 2006. The results for such period included within this report reflect the adjustment.

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 2,000 facilities in 47 states as of March 31, 2007. Although we do not directly participate in any government reimbursement programs, our clients

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reimbursements are subject to government regulation. Therefore, they are directly affected by any legislation relating to Medicare and Medicaid reimbursement programs.

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.

In addition to Summit (whose operations were fully integrated into Healthcare's on January 1, 2007), 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 March 31, | |
| | 2007 | 2006 |
| Revenues | 100.0% | 100.0% |
| Operating costs and expenses: | | |
| Costs of services provided | 84.8 | 85.9 |
| Selling, general and administration | 7.5 | 7.6 |
| Investment and interest income | .9 | 1.1 |
| Income before income taxes | 8.6 | 7.6 |
| Income taxes | 3.3 | 2.8 |
| Net income | 5.3% | 4.8% |

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 2007 to be comparable to the three month period ended March 31, 2007 percentages presented in the above table as they relate to consolidated revenues. Although future expense associated with our ESPP may vary and impact future 2007 periods as such expense is dependent on the change

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in our stock price over the remaining period up to the December 31, 2007 measurement date. Additionally, future 2007 periods may be impacted by any grant of stock options which would require us to recognize share-based payments expense which could be material dependent on the factors pertaining to the issuance.

Housekeeping is our largest and core reportable segment, representing approximately 81% of consolidated revenues for the quarter ended March 31, 2007. Food revenues represented approximately 19% of consolidated revenues for such quarter.

Although there can be no assurance thereof, we believe that for the remainder of 2007 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 2007 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.

2007 First Quarter Compared with 2006 First Quarter

The following table sets forth 2007 first 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 2006 first quarter amounts.

| | Consolidated | Percent incr (decr) | Corporate and eliminations | Reportable Segments | | | |
|--|---------------|---------------------------|-------------------------------|------------------------|-------|----------------|-------|
| | | | | Housekeeping Amount | %incr | Food Amount | %incr |
| Revenues | \$140,679,000 | 18.3% | \$ 925,000 | \$113,201,000 | 19.3% | \$26,553,000 | 15.2% |
| Cost of services provided | 119,314,000 | 16.8 | (7,939,000) | 101,881,000 | 19.2 | 25,372,000 | 13.6 |
| Selling, general and administrative expense | 10,511,000 | 15.8 | 10,511,000 | | | | |
| Investment and interest Income | 1,261,000 | (6.4) | 1,261,000 | | | | |
| Income before income taxes | \$ 12,115,000 | 34.5% | (386,000) | \$ 11,320,000 | 20.2 | \$ 1,181,000 | 68.1 |

Revenues**Consolidated**

Consolidated revenues increased 18.3% to \$140,679,000 in the 2007 first quarter compared to \$118,918,000 in the 2006 first quarter as a result of the factors discussed below under Reportable Segments.

Our Major Client accounted for 16% and 19%, respectively of consolidated revenues in the three month periods ended March 31, 2007 and March 31, 2006. 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 our Major 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

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operations of our two operating segments. In addition, if such Major 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.

Reportable Segments

Housekeeping's 19.3% net growth in reportable segment revenues resulted primarily from a 10.7% increase in revenues related to the Summit acquisition and 8.6% increase in revenues attributable to service agreements entered into with new clients.

Food's 15.2% net growth in reportable segment revenues is primarily a result of providing this service to existing Housekeeping clients. The Summit acquisition accounted for 3.2% of such increase.

We derived 15% and 22%, respectively, of Housekeeping and Food's 2007 first quarter revenues from our Major Client.

Costs of services provided**Consolidated**

Cost of services provided, on a consolidated basis, as a percentage of consolidated revenues for the 2007 first quarter decreased to 84.8 % from 85.9 % in the corresponding 2006 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 | 2007 % | 2006 % | Incr (Decr) % |
|---|--------|--------|------------------|
| Bad debt provision | 1.4 | .3 | 1.1 |
| Workers' compensation and general liability insurance | 3.0 | 3.6 | (.6) |

The increase in bad debt provision resulted from a nursing home chain filing bankruptcy during the first quarter of 2007. The decrease in workers' compensation and general liability insurance is primarily a result of reduced payments to claimants due to improved claims' experience.

In addition to the key indicators managed on a consolidated basis, the 1.1% decrease in cost of services provided resulted as well from decreases in labor and other labor costs, and housekeeping and food supplies' expenses discussed below in Reportable Segments.

Reportable Segments

Cost of services provided for Housekeeping, as a percentage of Housekeeping revenues, for the 2007 first quarter decreased slightly to 90.0% from 90.1% in the corresponding 2006 quarter. Cost of services provided for Food, as a percentage of Food revenues, for the 2007 first quarter decreased to 95.6% from 96.9% in the corresponding 2006 quarter.

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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 | 2007 % | 2006 % | Decr % |
|--|--------|--------|--------|
| Housekeeping labor and other labor costs | 81.2 | 81.3 | (.1) |
| Housekeeping segment supplies | 4.7 | 5.4 | (.7) |
| Food labor and other labor costs | 54.0 | 54.6 | (.6) |
| | | | (|
| Food segment supplies | 36.2 | 37.7 | 1.5) |

The decrease in Housekeeping labor and other labor costs, as a percentage of Housekeeping revenues, resulted primarily from efficiencies achieved at the facility level and benefits from the restructuring of our district management network pursuant to the full integration of Summit into our operations as of January 1, 2007.

The decrease in Housekeeping supplies, as a percentage of Housekeeping revenues, resulted primarily from efficiencies in the purchasing of our laundry and linen services' supplies.

The decrease in Food labor and other labor costs, as percentage of Food revenues, resulted primarily from efficiencies achieved.

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 18.3% growth in consolidated revenues, selling, general and administrative expenses increased by 15.8% or \$1,437,000. However, as a percentage of total consolidated revenues, these expenses decreased slightly to 7.5% in the 2007 first quarter compared to 7.6% in the 2006 first quarter. This percentage decrease resulted primarily from our ability to control these expenses and comparing them to a greater revenue base in the current period. Additionally, as disclosed in Note 10 to the Notes to the Consolidated Financial Statements, 2006 first quarter consolidated selling, general and administrative expense reported herein reflects an adjustment, from the previously reported amount, of approximately \$183,000 (\$115,000 net of income taxes) resulting from our 2006 cumulative effect of adjustment to deferred compensation liability.

Consolidated Investment and Interest Income

Investment and interest income, as a percentage of consolidated revenues, decreased slightly to .9% in the 2007 first quarter compared to 1.1% in the 2006 first quarter. The decrease is primarily the result of comparing the investment income to a greater revenue base.

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Income before Income Taxes

Consolidated

Consistent with the discussion above related to revenues and expenses, consolidated income before income taxes for the 2007 first quarter increased to 8.6 %, as a percentage of consolidated revenues, compared to 7.6% in the 2006 first quarter.

Reportable Segments

Housekeeping s 20.2% increase in income before income taxes is attributable to the improvement in the gross profit earned at the facility level of clients currently serviced, as well as the gross profit earned on the 19.3% increase in reportable segment revenues.

Food s income before income taxes increased 68.1% on a reportable segment basis which is primarily attributable to an improvement in the gross profit earned at the client facility level of clients currently serviced, as well as the gross profit earned on the 15.2% increase in reportable segment revenues.

Consolidated Income Taxes

Our effective tax rate at March 31, 2007 was 38.5% compared to our March 31, 2006 effective tax rate of 37%. The increase in the effective tax rate is primarily attributable to the reduction in tax credits available to the company and graduated income tax rates being applied against increased levels of taxable income. Our 38.5% effective tax rate differs from the federal income tax statutory rate principally because of the effect of state and local income taxes and estimated tax credits available to the company.

Consolidated Net Income

As a result of the matters discussed above, consolidated net income for the 2007 first quarter increased to 5.3%, as a percentage of consolidated revenues, compared to 4.8% in the 2006 first quarter.

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 three policies discussed below to be critical to an understanding of our financial statements because their application places the most significant demands on management s 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.

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The three 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 on Form 10-K for the year ended December 31, 2006, which contain 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 (the Allowance) is established as losses are estimated to have occurred through a provision for bad debts charged to earnings. The Allowance 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 evaluations, 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 such receivables. We generally follow a policy of reserving for receivables due from clients in bankruptcy, clients with which we are in litigation for collection 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.

Our methodology for the Allowance is based upon a risk-based evaluation of accounts and notes receivable associated with a client's ability to make payments. Such Allowance generally consists of an initial amount established based upon criteria generally applied if and when a client account files bankruptcy, is placed for collection/litigation and/or is considered to be pending collection/litigation.

The initial Allowance is adjusted either higher or lower when additional information is available to permit a more accurate estimate of the collectibility of an account.

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Summarized below for the three month period ended March 31, 2007 and year ended December 31, 2006 are the aggregate account balances for the three Allowance criteria noted above, net write-offs of client accounts, bad debt provision and allowance for doubtful accounts.

| Period Ended | Aggregate Account Balances of Clients in Bankruptcy or In/Pending Collection/Litigation | Net Write-Offs of Client Accounts | Bad Debt Provision | Allowance for Doubtful Accounts |
|-------------------|---|---|-----------------------|---------------------------------------|
| March 31, 2007 | \$ 10,978,000 | \$ 81,000 | \$ 1,977,000 | \$ 4,612,000 |
| December 31, 2006 | \$ 6,098,000 | \$ 181,000 | \$ 622,000 | \$ 2,716,000 |

At March 31, 2007, we identified accounts totaling \$10,978,000 that require an Allowance based on potential impairment or loss of value. An Allowance totaling \$4,612,000 was provided for these accounts at such date. Actual collections of these accounts could differ from that which we currently estimate. If our actual collection experience is 5% less than our estimate, the related increase to our Allowance would decrease net income by \$196,000.

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 2006 Annual Report on Form 10-K in Part I under Risk Factors, Government Regulation of Clients and Service Agreements/Collections, 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 29% of our liabilities at March 31, 2007. 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, predetermined 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

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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 \$45,000. Additionally, reducing the estimated payout period by six months would result in an approximate \$92,000 reduction in net income.

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.

Asset Valuations and Review for Potential Impairment

We review our fixed assets, goodwill and other intangible assets at least annually or whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. This review requires that we make assumptions regarding the value of these assets and the changes in circumstances that would affect the carrying value of these assets. If such analysis indicates that a possible impairment may exist, we are then required to estimate the fair value of the asset and, as deemed appropriate, expense all or a portion of the asset. The determination of fair value includes numerous uncertainties, such as the impact of competition on future value. We believe that we have made reasonable estimates and judgments in determining whether our long-term assets have been impaired; however, if there is a material change in the assumptions used in our determination of fair value or if there is a material change in economic conditions or circumstances influencing fair value, we could be required to recognize certain impairment charges in the future. As a result of our most recent reviews, no changes in asset values were required except for recording a \$27,000 increase in goodwill relating to the Summit acquisition resulting from additional professional fees incurred in the 2007 first quarter.

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Liquidity and Capital Resources

At March 31, 2007, we had cash and cash equivalents of \$78,999,000 and working capital of \$148,194,000 compared to December 31, 2006 cash and cash equivalents of \$72,997,000 and working capital of \$140,627,000. We view our cash and cash equivalents as our principal measure of liquidity. Our current ratio at March 31, 2007 decreased to 5.9 to 1 compared to 6.1 to 1 at December 31, 2006. This decrease 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 positions will enable us to fund our continued anticipated growth.

Operating Activities

The net cash provided by our operating activities was \$7,170,000 for the three month period ended March 31, 2007. The principal sources of net cash flows from operating activities for the three month period ended March 31, 2007 were net income, effected for non-cash charges to operations for bad debt provisions, and depreciation and amortization. Additionally, operating activities cash flows increased by \$6,242,000 as a result of the timing of payments for accrued payroll, accrued and withheld payroll taxes. The operating activity that used the largest amount of cash during the three month period ended March 31, 2007 was a net increase of \$4,802,000 in accounts and notes receivable and long-term notes receivable resulting primarily from the 18.3% growth in the Company's 2007 first quarter revenues.

Investing Activities

Our principal use of cash in investing activities for the three month period ended March 31, 2007 was \$415,000 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 \$1,500,000 to \$2,500,000 during the remainder of 2007 for such capital expenditures.

Financing Activities

On February 14, 2007 we paid, to shareholders of record on February 5, 2007, a regular quarterly cash dividend of \$.14 per common share. Such regular quarterly cash dividend payment in the aggregate was \$3,887,000. Additionally, on April 17, 2007, our Board of Directors declared a regular cash dividend of \$.15 per common share to be paid on May 11, 2007 to shareholders of record as of April 27, 2007.

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 first quarter of 2007, we received proceeds of \$1,697,000 from the exercise of stock options by employees and directors. Additionally, we recognized an income tax benefit of \$1,307,000 from equity compensation plans transactions.

Line of Credit

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We have a \$30,000,000 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 March 31, 2007, there were no borrowings under the line. However, at such date, we had outstanding a \$27,725,000 irrevocable standby letter of credit which relate to payment obligations under our insurance programs. As a result of the letter of credit issued, the amount available under the line of credit was reduced by \$27,725,000 at March 31, 2007.

The line of credit requires us to satisfy two financial covenants. Such covenants, and their respective status at March 31, 2007, were as follows:

| Covenant Description and Requirement | Status at March 31, 2007 |
|--|----------------------------|
| Commitment coverage ratio: cash and cash equivalents must equal or exceed outstanding obligations under the line by a multiple of 2. | Commitment coverage is 2.9 |

| | |
|--|-------------------------------------|
| Tangible net worth: must exceed \$128,000,000. | Tangible net worth is \$151,940,000 |
|--|-------------------------------------|

As noted above, we complied with the financial covenants at March 31, 2007 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. Congress has enacted a number of 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 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 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 March 31, 2007 and December 31, 2006, we had \$13,700,000 and \$13,406,000, 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 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

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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 \$1,977,000 in the three month period ended March 31, 2007 and \$375,000 in the three month period ended March 31, 2006. These provisions represent approximately 1.4% and .3%, as a percentage of total revenues for such respective periods. 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 March 31, 2007, amounts due from our Major Client represented less than 1% of our accounts receivable balance. If such client changes its payments terms, it would increase our accounts receivable balance and have a material adverse affect on our cash flows and cash and cash equivalents.

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.

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.

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Capital Expenditures

The level of capital expenditures is generally dependent on the number of new clients obtained. Such capital expenditures primarily consist of 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 2007, we estimate that for the remainder of 2007 we will have capital expenditures of approximately \$1,500,000 to \$2,500,000 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 through such cost increases to our clients.

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ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Management does not believe that there is any material market risk exposure with respect to derivative or other financial instruments that would require disclosure under this item.

ITEM 4. 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.

Based on their evaluation as of March 31, 2007, pursuant to Exchange Act Rule 13a-15(b), our management, including our Chief Executive Officer and Chief Financial Officer, believe our disclosure controls and procedures (as defined in Exchange Act 13a-15(e) are effective.

In connection with the evaluation pursuant to Exchange Act Rule 13a-15(d) of our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) by our management, including our Chief Executive Officer and Chief Financial Officer, no changes during the quarter ended March 31, 2007, were identified that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

There has been no material change in the risk factors set forth in Part I, Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

ITEM 3. Defaults under Senior Securities. Not Applicable

ITEM 4. Submission of Matters to a Vote of Security Holders Not Applicable

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, 18 U.S.C. Section 1350.

32.2 Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.

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SIGNATURES

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

HEALTHCARE SERVICES GROUP,
INC.

April 23, 2007
Date

/s/ Daniel P. McCartney

DANIEL P. McCARTNEY, Chief
Executive Officer

April 23, 2007
Date

/s/ Thomas A. Cook

THOMAS A. COOK, President and
Chief Operating Officer

April 23, 2007
Date

/s/ Richard W. Hudson

RICHARD W. HUDSON, Chief
Financial Officer and Secretary

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