



2005



the premiere provider of housekeeping, laundry, linen, food and facility maintenance services to the long-term healthcare industry

Healthcare Services Group, Inc.

2005 Annual Report

Healthcare Services Group, Inc.

Since its formation in 1977, Healthcare has been in the forefront of providing housekeeping, laundry, linen, facility maintenance and more recently, food services resulting in a current client base of over 1,700 nursing homes, retirement facilities, rehabilitation centers and hospitals.

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Financial Highlights

(in thousands except per share data and employees)

Years Ended December 31,

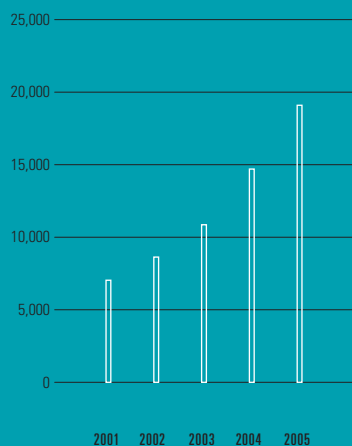
	2005	2004	2003	2002	2001
Revenues	\$ 466,291	\$ 442,568	\$ 379,718	\$ 328,500	\$ 284,190
Net income	\$ 19,096	\$ 14,699	\$ 10,860	\$ 8,631	\$ 7,035
Basic earnings per common share	\$.71	\$.56 ¹	\$.42 ¹	\$.34 ¹	\$.29 ¹
Diluted earnings per common share	\$.67	\$.53 ¹	\$.41 ¹	\$.33 ¹	\$.28 ¹
Cash Dividends per common share	\$.30	\$.17 ¹	\$.06 ¹	\$ —	\$ —
Weighted average number of common shares outstanding for basic EPS	26,921	26,221 ¹	25,574 ¹	25,342 ¹	24,588 ¹
Weighted average number of common shares outstanding for diluted EPS	28,320	27,660 ¹	26,682 ¹	26,301 ¹	24,925 ¹

As of December 31,

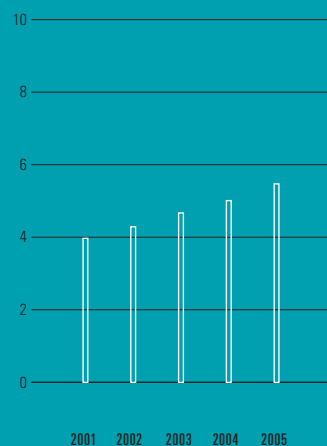
	2005	2004	2003	2002	2001
Working capital	\$ 142,535	\$ 125,012	\$ 112,073	\$ 96,117	\$ 84,089
Total assets	\$ 188,430	\$ 166,964	\$ 158,328	\$ 134,296	\$ 120,790
Stockholders' equity	\$ 148,163	\$ 131,460	\$ 121,198	\$ 107,881	\$ 98,943
Book value per common share	\$ 5.47	\$ 5.01 ¹	\$ 4.67 ¹	\$ 4.29 ¹	\$ 3.97 ¹
Employees	20,400	19,900	18,400	16,100	15,900

(1) Adjusted to reflect the 3-for-2 Stock Split paid in the form of a 50% Common Stock Dividend on May 2, 2005.

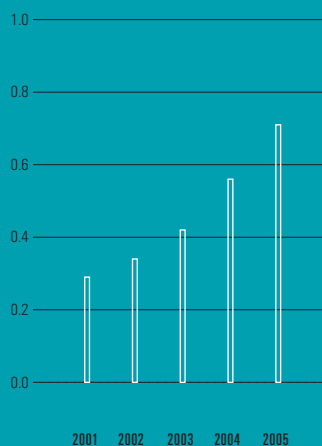
Net Income
(in thousands)



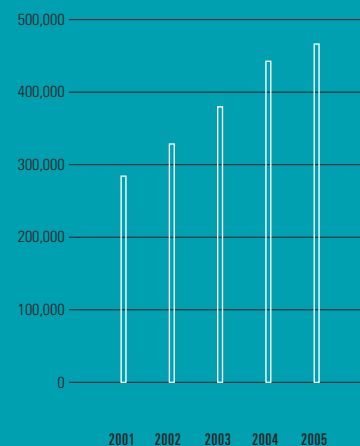
Book Value per Common Share



Basic Earnings per Common Share



Revenues
(in thousands)



We are pleased to report that again in 2005 our Company's financial performance reached new heights.

Dear Shareholders:

- Revenues:
\$466,291,000- a 5% increase over 2004 revenues
- Net income:
\$19,096,000- a 30% increase over 2004 net income
- Diluted earnings per common share:
\$.67- a 26% increase over 2004 diluted earnings per common share
- Total cash dividend payments in 2005: \$.30 per common share- a 76% increase over total cash dividend payments in 2004

These record results were achieved through revenue and net income growth in both our housekeeping and food operating segments. Most significantly, we are pleased by the 36% increase in the food segment's 2005 net income compared to 2004 net income. We believe this growth is a sign of the improved utilization and maturity of our food segment management organization and this improvement should continue.

As an outcome of 2005's record results and our strong financial position, the Board of Directors increased quarterly cash dividend payments in every quarter of 2005. This trend has continued into 2006, as the Board of Directors declared a quarterly cash dividend payment of \$.10 per common share which was paid on February 13, 2006. This quarterly cash dividend was our eleventh consecutive quarterly cash dividend payment, as well as the tenth consecutive increase since our initiation of quarterly cash dividend payments.

The Company has also expended approximately \$29,000,000, including almost \$4,000,000 in 2005, to increase shareholder value by buying back almost 6,000,000 shares of our common stock (adjusted for stock splits) since instituting a "Share Buy-Back" program. As of December 31, 2005, we have remaining approximately 1,300,000 shares of common stock authorized for buy-back pursuant to prior Board of Directors' approvals.

Our extraordinary record of consistent performance is primarily a result of our focus on maintaining a commitment to every one of our clients to deliver a service of the highest quality with an emphasis on cost containment. We are able to accomplish this through fostering a partnership relationship between our management and that of our clients. Our decentralized management system not only gives our people a sense of direct responsibility and ownership in addressing clients' needs, but more importantly positions our management people, as the Company representative, in front of the client on a consistent basis. It is this ongoing interaction between our management and the client which is the essence of our business model of having our clients see us as a partner in their day-to-day operation. We realize that a primary goal of our clients when engaging us is to have their overall operations run more efficiently. It is our ability to consistently and reliably provide our services which fosters our partnership with our clients and helps them meet their goals.

All of the management and workforce at Healthcare begin 2006 with enthusiasm and a commitment to remain focused on the strategies which have worked so well for us during the past 30 years enabling us to become the provider of choice for our services within the long-term care industry. The results and business accounts reported in the following pages enable us to proudly state that we are confident we can maintain strong business growth and increase shareholder value.



Daniel P. McCartney
Chairman & Chief Executive Officer



Thomas A. Cook
President & Chief Operating Officer

Our Services



Housekeeping services consist of the cleaning, disinfecting and sanitizing of all areas in the facility, including resident and patient rooms, auxiliary areas, and main access areas such as the lobby, public rest rooms, offices and corridors. Our on-site management team provides continuous employee supervision, training and evaluation. We also conduct periodic testing for the purpose of infection control.



Laundry and Linen services consist of laundering and processing the personal clothing of residents and patients, as well as the providing, collecting and laundering of sheets, pillow cases, blankets and other linen items used in a health care facility. Additionally, we work closely with the facility to design, install, operate and maintain an on-premise laundry.

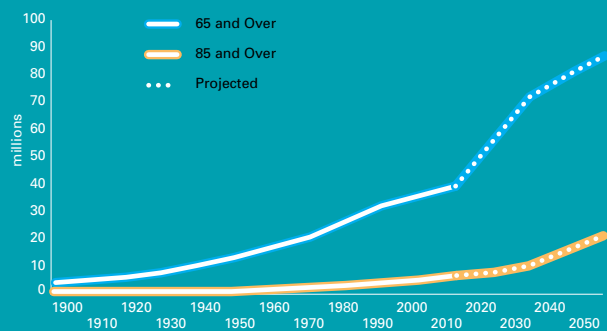
Food services consist of the development of a menu that meets the residents' dietary needs, purchasing and preparing the food to assure the residents and patients receive an appetizing meal, and participation in monitoring of the residents' ongoing nutrition status. On-site management is responsible for all daily food service activities with regular support being provided by a district manager specializing in food service and a registered dietitian.

Facility maintenance & plant management services consist of the repair and preventive maintenance of the building and equipment at a specific facility.



The Market:

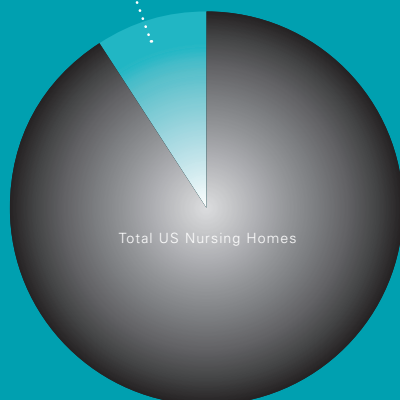
Number of People age 65 and over 1900-2000, projected 2010-2050



Our clients have experienced unprecedented growth in their industry, with expectations that it will continue at an accelerated pace. The United States Census Bureau states that there are currently over 35 million citizens over age 65, which represents approximately 13 percent of the United States population.

Opportunity for Expansion

Nursing Homes under Contract with HCSG





Healthcare Services Group, Inc. has witnessed a major reshaping of the methods of delivering long-term care and other associated needs of the elderly, developmentally disabled or infirmed during its thirty years of service to the health care industry. The elderly population is expected to increase to approximately 70 million or more than 20 percent of the total population by the year 2030. Integral to this growth of the elderly population is their need for long-term care. As more of the population live extended lives, their potential for the need of some form of post-acute care is more essential.

The increased demand for facilities providing post-acute/long-term care is demonstrated by the fact that the U.S. Census Bureau predicts that the elderly population is projected to double between the years 2000 and 2040. Additionally, nearly 50 percent of the over-85 population segment, which is the fastest growing segment of the elderly population, currently require some type of long-term care while approximately 25 percent of this age segment currently reside in nursing homes. The industry in which we operate is affected by many other factors besides the growth in the elderly population. Most significant is the various economic and political pressures present in today's health care environment. Many operators of health care facilities are strained, financially and in providing services, because of the new reformed health care environment that has developed.



Our Goal is to Provide the best service in the industry

A health care facility derives many benefits from operating a spotlessly clean, aesthetically pleasing environment. Our staff is thoroughly trained to perform housekeeping, laundry, linen, facility maintenance and food service responsibilities with skill and sensitivity. Stringent quality-assurance standards insure that a facility will receive the most professional services in the industry.

Our Guidelines:

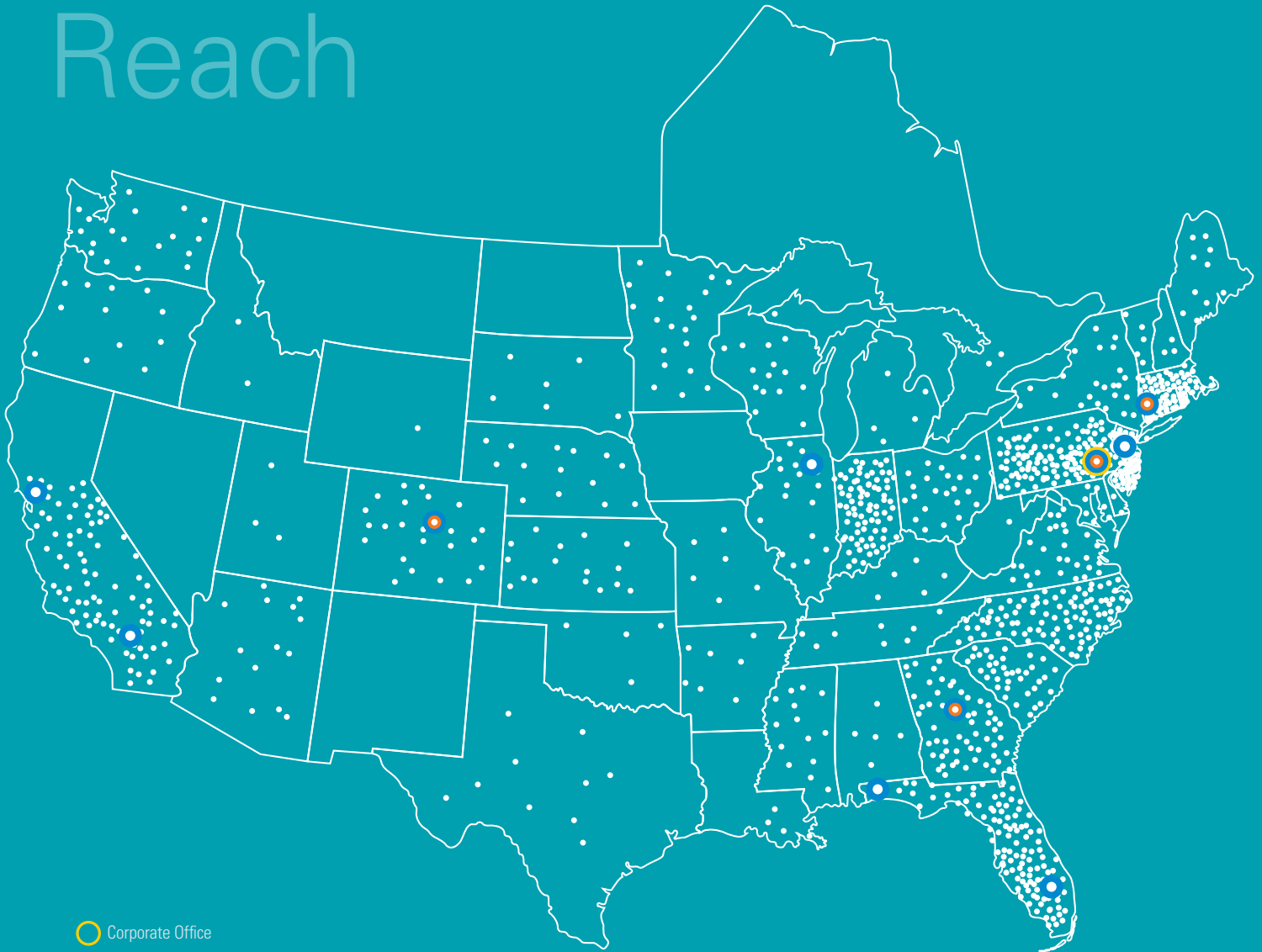
Develop a strong and well coordinated management team

The key to our client retention rate and orderly geographic expansion has been our ability to assemble the finest group of managers in the industry. Clients, who receive daily support from on-site management, are also actively supported by a Company District Manager who is in close proximity to the client. The development of experienced management back-up is reassuring to owners and administrators. Reducing client costs while improving overall quality is a most challenging assignment. This objective is met by standardizing operating systems, maintaining strict controls through a quality-assurance program and planning efficient production schedules.

Concentrate on what we do best

Companies which diversify outside their core business often suffer diminishing returns. Healthcare Services Group, Inc., has prospered by providing exemplary housekeeping, laundry, linen, facility maintenance and food services to an increasing number of satisfied clients. This is what we always have done and what we will continue to do.

Reach



- Corporate Office
- Divisional Office
- Regional Office

Healthcare Services Group, Inc. is a leader in providing contractual housekeeping, laundry, linen, facility maintenance and food services for the health care industry. Services are provided to 1,700 nursing homes, rehabilitation facilities, retirement centers, and hospitals in 45 states and Canada.

Partnership responsibility means thorough understanding of our client's needs to deliver high quality care to residents and patients of health care facilities.

The following discussion and analysis should be read in conjunction with the Financial Statements and Notes thereto.

SELECTED FINANCIAL DATA

The selected financial data presented below should be read in conjunction with, and is qualified in its entirety by reference to the Financial Statements and Notes thereto.

(in thousands except for per share data and employees)

Years Ended December 31:

	2005	2004	2003	2002	2001
Revenues	\$466,291	\$442,568	\$379,718	\$328,500	\$284,190
Net income	\$ 19,096	\$ 14,699	\$ 10,860	\$ 8,631	\$ 7,035
Basic earnings per common share	\$.71	\$.56 ¹	\$.42 ¹	\$.34 ¹	\$.29 ¹
Diluted earnings per common share	\$.67	\$.53 ¹	\$.41 ¹	\$.33 ¹	\$.28 ¹
Cash dividends per common share	\$.30	\$.17 ¹	\$.06 ¹	\$ —	\$ —
Weighted average number of common shares outstanding for basic EPS	26,921	26,221 ¹	25,574 ¹	25,342 ¹	24,588 ¹
Weighted average number of common shares outstanding for diluted EPS	28,320	27,660 ¹	26,682 ¹	26,301 ¹	24,925 ¹

As of December 31:

Working Capital	\$142,535	\$125,012	\$112,073	\$ 96,117	\$ 84,089
Total Assets	\$188,430	\$166,964	\$158,328	\$134,296	\$120,790
Stockholders' Equity	\$148,163	\$131,460	\$121,198	\$107,881	\$ 98,943
Book Value Per Common Share	\$ 5.47	\$ 5.01 ¹	4.67 ¹	4.29 ¹	3.97 ¹
Employees	20,400	19,900	18,400	16,100	15,900

¹Adjusted to reflect the 3 for 2 Stock Split paid in the form of a 50% Common Stock Dividend on May 2, 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Statement Regarding Forward Looking Statements

This report includes forward-looking statements that are subject to risks and uncertainties that could cause actual results or objectives to differ materially from those projected. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Such risks and uncertainties include, but are not limited to, risks arising from our providing services exclusively to the health care industry, primarily providers of long-term care; credit and collection risks associated with this industry; one client accounting for approximately 19% of revenues in 2005 (the client entered into a merger agreement on August 16, 2005 and the transaction is expected to close in the first quarter of 2006—see Note 1, “Major Client” in the following Notes to Consolidated Financial Statements); our claims experience related to workers’ compensation and general liability insurance; the effects of changes in, or interpretations of laws and regulations governing the industry, including state and local regulations pertaining to the taxability of our services; and the risk factors described in our Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2005 and in Part I thereof under “Government Regulation of Clients”, “Competition” and “Service Agreements/Collections”. Many of our clients’ revenues are highly contingent on Medicare and Medicaid reimbursement funding rates, which have been and continue to be adversely affected by the change in Medicare payments under the 1997 enactment of the Medicare Prospective Payment System. That change, and the lack of substantive reimbursement funding rate reform legislation, as well as other trends in the long-term care industry have resulted in certain of our clients filing for bankruptcy protection. Others may follow. Any decisions by the government to discontinue or adversely modify legislation related to reimbursement funding rates will have a material adverse effect on our clients. These factors, in addition to delays in payments from clients have resulted in and could continue to result in significant additional bad debts in the near future. Additionally, our operating results would be adversely affected if unexpected increases in the costs of labor and labor related costs, materials, supplies and equipment used in performing services could not be passed on to our clients.

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

Results of Operations

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

Overview

We provide housekeeping, laundry, linen, facility maintenance and food services to the health care industry, including nursing homes, retirement complexes, rehabilitation centers and hospitals located throughout the United States. We believe that we are the largest provider of housekeeping and laundry services to the long-term care industry in the United States, rendering such

services to approximately 1,700 facilities in 45 states as of December 31, 2005. 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.

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

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

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

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

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

Consolidated Operations

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

	<i>Relation to Consolidated Revenues</i>		
	<i>Years Ended December 31,</i>		
	2005	2004	2003
Revenues	100.0%	100.0%	100.0%
Operating costs and expenses:			
Costs of services provided	87.1	87.8	88.1
Selling, general and administration	7.0	7.1	7.6
Investment and interest income	<u>.7</u>	<u>.3</u>	<u>.4</u>
Income before income taxes	6.6	5.4	4.7
Income taxes	<u>2.5</u>	<u>2.0</u>	<u>1.8</u>
Net income	<u>4.1%</u>	<u>3.4%</u>	<u>2.9%</u>

Subject to the factors noted in the Cautionary Statement Regarding Forward Looking Statements included in this report, we anticipate our financial performance in 2006 to be comparable to the 2005 percentages presented in the above table as they relate to consolidated revenues.

Housekeeping is our largest and core reportable segment, representing approximately 80% of 2005 consolidated revenues. Food revenues represented approximately 20% of 2005 consolidated revenues.

Although there can be no assurance thereof, we believe that in 2006 each of Housekeeping's and Food's revenues, as a percentage of consolidated revenues, will remain approximately the same as their respective 2005 percentages noted above. Furthermore, we expect the sources of growth in 2006 for the respective operating segments will be primarily the same as historically experienced.

Accordingly, although there can be no assurance thereof, the growth in Food is expected to come from our current Housekeeping client base, while growth in Housekeeping will primarily come from obtaining new clients.

2005 Compared with 2004

The following table sets forth 2005 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 2004 amounts.

	Consolidated	Percent increase	Corporate and eliminations	Reportable Segments			
				Housekeeping		Food	
				Amount	%incr	Amount	%incr
Revenues	\$466,291,000	5.4%	\$ (1,706,000)	\$375,133,000	4.9%	\$92,864,000	6.4%
Cost of services provided	406,114,000	4.5	(27,340,000)	343,224,000	4.5	90,230,000	5.7
Selling, general and administrative	32,576,000	3.3	32,576,000	—		—	
Income before income taxes	30,799,000	29.9	(3,744,000)	31,909,000	8.8	2,634,000	36.2

Revenues

Consolidated

Consolidated revenues increased 5.4% to \$466,291,000 in 2005 compared to \$442,568,000 in 2004 as a result of the factors discussed below under Reportable Segments.

We have one client, a nursing home chain (“Major Client”), which in 2005 and 2004 accounted for 19% and 20%, respectively, of consolidated revenues. At both December 31, 2005 and 2004 amounts due from such client represented less than 1% of our accounts receivable balance. According to public filings, the client entered into a merger agreement on August 16, 2005 and the transaction is expected to close in the first quarter of 2006. Although we expect to continue our relationship with this client’s successor, there can be no assurance thereof, and the loss of such client would have a material adverse effect on our consolidated results of operations. Additionally, if such client’s successor changes its payment terms it would increase our accounts receivable balance and have a material adverse effect on our cash flows and cash and cash equivalents.

Reportable Segments

Housekeeping’s 4.9% net growth in reportable segment revenues is primarily a result of an increase in service agreements entered into with new clients.

Food’s 6.4% net growth in reportable segment revenues is a result of providing this service to an increasing number of existing Housekeeping clients.

We derived 18% and 27%, respectively, of Housekeeping and Food’s 2005 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 2005 decreased to 87.1 % from 87.8 % in 2004. 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	2005%	2004%	(Decr)%
Bad debt provision	.3	.8	(.5)
Workers’ compensation and general liability insurance	3.9	4.0	(.1)

The decrease in bad debt provision resulted primarily from improved collection experience. The workers' compensation and liability insurance expense decrease is primarily a result of a current reduction in the average claim cost.

Reportable Segments

Cost of services provided for Housekeeping, as a percentage of Housekeeping revenues, for 2005 decreased to 91.5% from 91.8% in 2004. Cost of services provided for Food, as a percentage of Food revenues, for 2005 decreased to 97.2% from 97.8% in 2004.

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:

<u>Cost of Services Provided-Key Indicators</u>	<u>2005%</u>	<u>2004%</u>	<u>Incr (Decr)%</u>
Housekeeping labor and other labor costs	82.4	82.7	(.3)
Housekeeping segment supplies	5.5	5.2	.3
Food labor and other labor costs	54.9	54.9	—
Food segment supplies	38.6	38.7	(.1)

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

The minor 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 5.4% growth in consolidated revenues, selling, general and administrative expenses increased by \$1,053,000. However, as a percentage of total consolidated revenues, these expenses decreased to 7.0% in the 2005 as compared to 7.1% in 2004. The decrease is primarily attributable to our ability to control these expenses and comparing them to a greater revenue base in the current period.

Income before Income Taxes

Consolidated

As a result of the discussion above related to revenues and expenses, consolidated income before income taxes for 2005 increased to 6.6 %, as a percentage of consolidated revenues, compared to 5.4% in 2004.

Reportable Segments

Housekeeping's 8.8% increase in income before income taxes is attributable to the improvement in the gross profit earned at the client facility level and the gross profit earned on the 4.9% increase in reportable segment revenues.

Food's income before income taxes increased 36.2% on a reportable segment basis which is primarily attributable to an improvement in the gross profit earned at the client facility level and the gross profit earned on the 6.4% increase in reportable segment revenues.

Consolidated Investment and Interest Income

Investment and interest income, as a percentage of consolidated revenues, was .7% in 2005 compared to .3% in 2004. The increase is attributable to improved rates of return on the higher cash and cash equivalents' average balance and the increase in market value of the investments held in our Deferred Compensation Fund.

Consolidated Income Taxes

Our effective tax rate at both December 31, 2005 and 2004 was 38%. Absent any significant change in federal, or state and local tax laws, we expect our effective tax rate for 2006 to be approximately the same as realized in 2005. Our 38% effective tax rate differs from the federal income tax statutory rate principally because of the effect of state and local income taxes.

Consolidated Net Income

As a result of the matters discussed above, consolidated net income for 2005 increased to 4.1%, as a percentage of consolidated revenues, compared to 3.4% in 2004.

2004 Compared with 2003

The following table sets forth for 2004 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 (decreases) of each compared to 2003 amounts.

	Consolidated	Percent increase	Corporate and eliminations	Reportable Segments			
				Housekeeping		Food	
				Amount	%incr	Amount	%incr (decr)
Revenues	\$442,568,000	16.6%	\$ (2,495,000)	\$357,754,000	12.3%	\$87,309,000	40.4%
Cost of services provided	388,668,000	16.2	(25,125,000)	328,418,000	11.3	85,375,000	41.8
Selling, general and administrative	31,523,000	8.5	31,523,000	—	—	—	—
Income before income taxes	23,706,000	35.3	(7,564,000)	29,336,000	25.6	1,934,000	(1.5)

Revenues

Consolidated

Consolidated revenues increased 16.6% to \$442,568,000 in 2004 compared to \$379,718,000 in 2003 as a result of the factors discussed below under Reportable Segments.

Our Major Client accounted for 20% and 23% of consolidated revenues in 2004 and 2003, respectively.

Reportable Segments

Housekeeping's 12.3% net growth in reportable segment revenues is primarily a result of an increase in service agreements entered into with new clients.

Food's 40.4% net growth in reportable segment revenues is a result of providing this service to an increasing number of existing Housekeeping clients.

We derived 19% and 27%, respectively, of the Housekeeping and Food's 2004 revenues from our Major Client.

Costs of services provided

Consolidated

Cost of services provided, on a consolidated basis, as a percentage of consolidated revenues in 2004 decreased slightly to 87.8 % from 88.1 % in 2003. 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	2004%	2003%	Incr (Decr)%
Bad debt provision	.8	1.2	(.4)
Workers' compensation and general liability insurance	4.0	4.6	(.6)

The decrease in bad debt provision resulted primarily from improved collection experience. The decrease in workers' compensation and general liability insurance is primarily a result of a current reduction in average claim cost.

Reportable Segments

Cost of services provided for Housekeeping, as a percentage of Housekeeping revenues, for 2004 decreased to 91.8% from 92.7% in 2003. Cost of services provided for Food, as a percentage of Food revenues, for 2004 increased to 97.8% from 96.8% in 2003.

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

<u>Cost of Services Provided-Key Indicators</u>	<u>2004%</u>	<u>2003%</u>	<u>Incr (Decr)%</u>
Housekeeping labor and other labor costs	82.7	83.7	(1.0)
Housekeeping segment supplies	5.2	4.7	.5
Food labor and other labor costs	54.9	53.7	1.2
Food segment supplies	38.7	39.0	(.3)

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

The 1.2% increase in Food labor and other labor costs, as a percentage of Food revenues, resulted primarily from inefficiencies experienced in the management of these costs in connection with this segment's 40.4% growth in revenues. The decrease in Food supplies, as a percentage of Food revenues, is a result of price decreases in vendor purchasing agreements.

Consolidated Selling, General and Administrative Expense

Consistent with our 16.6% growth in consolidated revenues, selling, general and administrative expenses increased by \$2,478,000. However, as a percentage of total consolidated revenues, these expenses decreased to 7.1% in 2004 as compared to 7.6% in 2003. The decrease is primarily attributable to our ability to control these expenses and comparing them to a greater revenue base in the current period.

Income before Income Taxes

Consolidated

As a result of the discussion above related to revenues and expenses, consolidated income before income taxes for 2004 increased to 5.4 %, as a percentage of consolidated revenues, compared to 4.7% in 2003.

Reportable Segments

Housekeeping's 25.6% increase in income before income taxes is attributable to the improvement in the gross profit earned at the client facility level and the gross profit earned on the 12.3% increase in reportable segment revenues.

Food's income before income taxes decreased 1.5% on a reportable segment basis. The decrease is attributable to a lower gross profit earned at the client facility level resulting primarily from the discussion above related to labor and other labor costs increase.

Consolidated Investment and Interest Income

Investment and interest income, as a percentage of consolidated revenues, was .3% in 2004 compared to .4% in 2003. The slight decrease is primarily attributable to a reduction in interest income earned on clients' notes receivable as a result of having less outstanding balances on such notes during 2004.

Consolidated Income Taxes

Our effective tax rate at both December 31, 2004 and 2003 was 38%. Our 38% effective tax rate differs from the federal income tax statutory rate principally because of the effect of state and local income taxes.

Consolidated Net Income

As a result of the matters discussed above, consolidated net income for 2004 increased to 3.4%, as a percentage of consolidated revenues, compared to 2.9% in 2003.

Critical Accounting Policies and Estimates

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

The two policies discussed are not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, 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 this Annual Report, which contain accounting policies and other disclosures required by generally accepted accounting principles.

Allowance for Doubtful Accounts

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

We have had varying collection experience with respect to our accounts and notes receivable. When contractual terms are not met, we generally encounter difficulty in collecting amounts due from certain of our clients. Therefore, we have sometimes been required to extend the period of payment for certain clients beyond contractual terms. These clients include those who have terminated service agreements and slow payers experiencing financial difficulties. In making credit evaluations, in addition to analyzing and anticipating, where possible, the specific cases described above, we consider the general collection risks associated with trends in the long-term care industry. We also establish credit limits, perform ongoing credit 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 Doubtful Accounts for such receivables. We generally follow a policy of reserving for receivables from clients in bankruptcy, clients with which we are in litigation for collection and other slow paying clients. The reserve is based upon our estimates of ultimate collectibility. Correspondingly, once our recovery of a receivable is determined through either litigation, bankruptcy proceedings or negotiation to be less than the recorded amount on our balance sheet, we will charge-off the applicable amount to the Allowance for Doubtful Accounts.

At December 31, 2005, we identified accounts totaling \$2,960,000 that require an Allowance for Doubtful Accounts based on potential impairment or loss of value. An Allowance for Doubtful Accounts totaling \$2,275,000 was provided for these accounts at December 31, 2005. 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 for Doubtful Accounts would decrease net income by \$21,000.

Notwithstanding our efforts to minimize credit risk exposure, our clients could be adversely affected if future industry trends, as more fully discussed under Liquidity and Capital Resources below, and as further described in our Form 10-K filed with Securities and Exchange Commission for the year ended December 31, 2005 in Part I thereof under “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 36% of our liabilities at December 31, 2005. 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 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 \$76,000. Additionally, reducing the estimated payout period by six months would result in an approximate \$132,000 reduction in net income.

For general liability, we record a reserve for the estimated ultimate amounts to be paid for known claims.

Liquidity and Capital Resources

At December 31, 2005, we had cash and cash equivalents of \$91,005,000 and working capital of \$142,535,000 compared to December 31, 2004 cash and cash equivalents and working capital of \$74,847,000 and \$125,012,000, respectively. We view our cash and cash equivalents as our principal measure of liquidity. Our current ratio at December 31, 2005 remained the same as at December 31, 2004 of 7.2 to 1. 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 \$24,495,000 for the year ended December 31, 2005. The principal sources of net cash flows from operating activities for 2005 were net income, including non-cash charges to operations for bad debt provisions and depreciation. Additionally, operating activities’ cash flows increased by \$2,324,000 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 year ended December 31, 2005 was a net increase of \$3,895,000 in accounts and notes receivable and long-term notes receivable resulting primarily from the 5.4% growth in the Company’s 2005 revenues.

Investing Activities

Our principal use of cash in investing activities for the year ended December 31, 2005 was \$1,897,000 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 \$2,000,000 to \$3,000,000 during 2006 for such capital expenditures.

Financing Activities

During 2005, we paid to shareholders regular quarterly cash dividends in the aggregate of \$8,076,000. Such regular quarterly cash dividend payments of \$.06, \$.07, \$.08 and \$.09 per common share were paid on February 11, May 16, August 12, and November 18, 2005, respectively. Additionally, on January 24, 2006, our Board of Directors declared a regular quarterly cash dividend of \$.10 per common share to be paid on February 13, 2006 to shareholders of record as of February 3, 2006.

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 year ended December 31, 2005, we expended \$3,857,000 for the repurchase of 218,000 shares of our common stock. We remain authorized to purchase 1,282,000 shares pursuant to previous Board of Directors' actions.

During 2005, we received proceeds of \$5,549,000 from the exercise of stock options by employees and directors.

Line of Credit

We have a \$25,000,000 bank line of credit on which we may draw to meet short-term liquidity requirements in excess of internally generated cash flow. Amounts drawn under the line of credit are payable upon demand. At December 31, 2005, there were no borrowings under the line of credit. However, at such date, we had outstanding a \$17,925,000 (increased to \$23,925,000 on January 1, 2006) irrevocable standby letter of credit which relates 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 \$17,925,000 at December 31, 2005. The line of credit requires us to satisfy two financial covenants. Such covenants, and their respective status at December 31, 2005, were as follows:

<u>Covenant Description and Requirement</u>	<u>Status at December 31, 2005</u>
Commitment coverage ratio: cash and cash equivalents must equal or exceed outstanding obligations under the line of credit by a multiple of 2.	Commitment coverage is 5.1
Tangible net worth: must exceed \$112,000,000.	Tangible net worth is \$146,000,000

As noted above, we complied with both financial covenants at December 31, 2005 and expect to continue to remain in compliance with all such financial covenants. This line of credit expires on June 30, 2006. We believe the line of credit will be renewed at that time.

Accounts and Notes Receivable

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

has resulted in certain of our clients filing for bankruptcy protection. Others may follow. These factors, in addition to delays in payments from clients, have resulted in and could continue to result in significant additional bad debts in the near future. Whenever possible, when a client falls behind in making agreed-upon payments, we convert the unpaid accounts receivable to interest bearing promissory notes. The promissory notes receivable provide a means by which to further evidence the amounts owed and provide a definitive repayment plan and therefore may ultimately enhance our ability to collect the amounts due. At December 31, 2005 and December 31, 2004, we had \$8,514,000 and \$8,942,000, 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 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 \$1,425,000, \$3,700,000 and \$4,550,000 in the years ended December 31, 2005, 2004 and 2003, respectively. These provisions represent approximately .3%, .8% and 1.2%, 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 December 31, 2005, amounts due from our Major Client represented less than 1% of our accounts receivable balance. If such client's successor changes its payment terms, it would increase our accounts receivable balance and have a material adverse effect on our cash flows and cash and cash equivalents.

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.

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

Capital Expenditures

The level of capital expenditures is generally dependent on the number of new clients obtained. Such capital expenditures primarily consist of housekeeping equipment purchases, laundry and linen equipment installations, and computer hardware and

software. Although we have no specific material commitments for capital expenditures through the end of calendar year 2006, we estimate that for the period we will have capital expenditures of \$2,000,000 to \$3,000,000 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.

CONSOLIDATED BALANCE SHEETS

	December 31,	
	<u>2005</u>	<u>2004</u>
Assets		
Current Assets:		
Cash and cash equivalents	\$ 91,005,000	\$ 74,847,000
Accounts and notes receivable, less allowance for doubtful accounts of \$2,275,000 in 2005 and \$1,869,000 in 2004	59,197,000	55,725,000
Inventories and supplies	11,729,000	11,015,000
Deferred income taxes	355,000	574,000
Prepaid expenses and other	<u>3,330,000</u>	<u>3,110,000</u>
Total current assets	165,616,000	145,271,000
Property and Equipment:		
Laundry and linen equipment installations	2,416,000	2,329,000
Housekeeping equipment and office furniture	15,141,000	13,987,000
Autos and trucks	<u>79,000</u>	<u>80,000</u>
	17,636,000	16,396,000
Less accumulated depreciation	<u>12,892,000</u>	<u>11,592,000</u>
	4,744,000	4,804,000
COSTS IN EXCESS OF FAIR VALUE OF NET ASSETS ACQUIRED		
Less accumulated amortization of \$1,743,000 in 2005 and 2004	1,612,000	1,612,000
NOTES RECEIVABLE-long term portion, net of discount	4,555,000	5,557,000
DEFERRED COMPENSATION FUNDING	5,626,000	4,062,000
DEFERRED INCOME TAXES-long term portion	6,181,000	5,563,000
OTHER NONCURRENT ASSETS	<u>96,000</u>	<u>95,000</u>
TOTAL ASSETS	<u>\$188,430,000</u>	<u>\$166,964,000</u>
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	\$ 8,760,000	\$ 7,272,000
Accrued payroll, accrued and withheld payroll taxes	7,792,000	6,110,000
Other accrued expenses	657,000	1,692,000
Income taxes payable	1,467,000	1,016,000
Accrued insurance claims	<u>4,405,000</u>	<u>4,169,000</u>
Total current liabilities	23,081,000	20,259,000
ACCRUED INSURANCE CLAIMS — long term portion	10,277,000	10,227,000
DEFERRED COMPENSATION LIABILITY	6,909,000	5,018,000
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Common stock, \$.01 par value, 67,500,000 shares authorized, 28,677,000 shares issued in 2005 and 27,761,000 in 2004	287,000	277,000
Additional paid-in capital	48,603,000	39,374,000
Retained earnings	112,299,000	101,279,000
Common stock in treasury, at cost, 1,616,000 shares in 2005 and 1,488,000 shares in 2004	<u>(13,026,000)</u>	<u>(9,470,000)</u>
Total Stockholders' Equity	<u>148,163,000</u>	<u>131,460,000</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$188,430,000</u>	<u>\$166,964,000</u>

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Revenues	\$466,291,000	\$442,568,000	\$379,718,000
Operating costs and expenses:			
Cost of services provided	406,114,000	388,668,000	334,609,000
Selling, general and administrative	32,576,000	31,523,000	29,045,000
Other income:			
Investment and interest	3,198,000	1,329,000	1,451,000
Income before income taxes	30,799,000	23,706,000	17,515,000
Income taxes	11,703,000	9,007,000	6,655,000
Net income	<u>\$ 19,096,000</u>	<u>\$ 14,699,000</u>	<u>\$ 10,860,000</u>
Basic earnings per common share	<u>\$ 0.71</u>	<u>\$ 0.56</u>	<u>\$ 0.42</u>
Diluted earnings per common share	<u>\$ 0.67</u>	<u>\$ 0.53</u>	<u>\$ 0.41</u>
Cash dividends per common share	<u>\$ 0.30</u>	<u>\$ 0.17</u>	<u>\$ 0.06</u>
Basic weighted average number of common shares outstanding	<u>26,921,000</u>	<u>26,221,000</u>	<u>25,574,000</u>
Diluted weighted average number of common shares outstanding	<u>28,320,000</u>	<u>27,660,000</u>	<u>26,682,000</u>

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:			
Net Income	\$19,096,000	\$14,699,000	\$ 10,860,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	1,872,000	1,873,000	1,914,000
Bad debt provision	1,425,000	3,700,000	4,550,000
Deferred income taxes benefits	(399,000)	(986,000)	(174,000)
Tax benefit of stock option transactions	3,454,000	1,900,000	1,039,000
Non-employee stock-based compensation expense	35,000	—	—
Unrealized gain on deferred compensation fund investments	(705,000)	(336,000)	(418,000)
Changes in operating assets and liabilities:			
Accounts and notes receivable	(4,897,000)	(1,279,000)	(11,141,000)
Prepaid income taxes	—	—	884,000
Inventories and supplies	(714,000)	(560,000)	(1,792,000)
Notes receivable — long term portion	1,002,000	2,347,000	2,034,000
Deferred compensation funding	(859,000)	(879,000)	(954,000)
Accounts payable and other accrued expenses	453,000	1,553,000	1,865,000
Accrued payroll, accrued and withheld payroll taxes	2,324,000	(7,651,000)	3,177,000
Accrued insurance claims	285,000	2,481,000	4,104,000
Deferred compensation liability	1,892,000	1,521,000	1,602,000
Income taxes payable	452,000	837,000	179,000
Prepaid expenses and other assets	(221,000)	215,000	(985,000)
Net cash provided by operating activities	<u>24,495,000</u>	<u>19,435,000</u>	<u>16,744,000</u>
Cash flows from investing activities:			
Disposals of fixed assets	85,000	321,000	221,000
Additions to property and equipment	(1,897,000)	(2,387,000)	(2,309,000)
Net cash used in investing activities	<u>(1,812,000)</u>	<u>(2,066,000)</u>	<u>(2,088,000)</u>
Cash flows from financing activities:			
Treasury stock transactions in benefit plans	(173,000)	—	—
Acquisition of treasury stock	(3,857,000)	(6,026,000)	(164,000)
Dividends paid	(8,076,000)	(4,598,000)	(1,489,000)
Reissuance of treasury stock pursuant to Dividend Reinvestment Plan	32,000	11,000	2,000
Proceeds from the exercise of stock options	5,549,000	3,910,000	2,856,000
Net cash provided by (used in) financing activities	<u>(6,525,000)</u>	<u>(6,703,000)</u>	<u>1,205,000</u>
Net increase in cash and cash equivalents	16,158,000	10,666,000	15,861,000
Cash and cash equivalents at beginning of the year	<u>74,847,000</u>	<u>64,181,000</u>	<u>48,320,000</u>
Cash and cash equivalents at end of the year	<u>\$91,005,000</u>	<u>\$74,847,000</u>	<u>\$ 64,181,000</u>
Supplementary Cash Flow Information:			
Issuance of 90,000, 72,000, and 56,000 shares of Common Stock in 2005, 2004 and 2003, respectively, pursuant to Employee Stock Plans	<u>\$ 643,000</u>	<u>\$ 366,000</u>	<u>\$ 212,000</u>

See accompanying notes

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years Ended December 31, 2005, 2004 and 2003

	Common Stock Shares	Stock Amount	Additional Paid-in Capital	Total Retained Earnings	Treasury Stock	Stockholders' Equity
Balance, December 31, 2002	26,129,000	\$261,000	\$29,531,000	\$ 81,807,000	\$ (3,717,000)	\$107,882,000
Net income for the year				10,860,000		10,860,000
Exercise of stock options and other share-based compensation	780,000	8,000	2,848,000			2,856,000
Tax benefit arising from stock option transactions			1,039,000			1,039,000
Purchase of common stock for treasury (33,000 shares)					(164,000)	(164,000)
Shares issued pursuant to Employee Stock Plans (56,000 shares)			7,000		205,000	212,000
Cash dividends – \$.06 per common share				(1,489,000)		(1,489,000)
Shares issued pursuant to Dividend Reinvestment Plan (134 shares)			1,000		1,000	2,000
Balance, December 31, 2003	26,909,000	269,000	33,426,000	91,178,000	(3,675,000)	121,198,000
Net income for the year				14,699,000		14,699,000
Exercise of stock options and other share-based compensation	852,000	8,000	3,948,000		(46,000)	3,910,000
Tax benefit arising from stock option transactions			1,900,000			1,900,000
Purchase of common stock for treasury (579,000 shares)					(6,026,000)	(6,026,000)
Shares issued pursuant to Employee Stock Plans (72,000 shares)			94,000		272,000	366,000
Cash dividends – \$.17 per common share				(4,598,000)		(4,598,000)
Shares issued pursuant to Dividend Reinvestment Plan (792 shares)			6,000		5,000	11,000
Balance, December 31, 2004	27,761,000	277,000	39,374,000	101,279,000	(9,470,000)	131,460,000
Net income for the year				19,096,000		19,096,000
Exercise of stock options and other stock-based compensation, net of 14,000 shares tendered for payment	900,000	9,000	5,575,000			5,584,000
Tax benefit arising from stock option transactions			3,454,000			3,454,000
Purchase of treasury stock (218,000 shares)					(3,857,000)	(3,857,000)
Shares purchased and shares sold in employee Deferred Compensation Plan and other benefit plans (17,000 shares)					(173,000)	(173,000)
Shares issued pursuant to Employee Stock Plans (90,000 shares)	16,000	1,000	181,000		461,000	643,000
Cash dividends – \$.30 per common share				(8,076,000)		(8,076,000)
Shares issued pursuant to Dividend Reinvestment Plan (2,000 shares)			19,000		13,000	32,000
Balance, December 31, 2005	<u>28,677,000</u>	<u>\$287,000</u>	<u>\$48,603,000</u>	<u>\$112,299,000</u>	<u>\$(13,026,000)</u>	<u>\$148,163,000</u>

See accompanying notes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1—Summary of Significant Accounting Policies

Nature of Operations

We provide housekeeping, laundry, linen, facility maintenance and food services to the health care industry, including nursing homes, retirement complexes, rehabilitation centers and hospitals located throughout the United States. We believe that we are the largest provider of housekeeping and laundry services to the long-term care industry in the United States rendering such services to approximately 1,700 facilities in 45 states as of December 31, 2005. 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.

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

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

The services provided by Housekeeping consist primarily of the cleaning, disinfecting and sanitizing of patient rooms and common areas of a client's facility, as well as the laundering and processing of the personal clothing belonging to the facility's patients. Also within the scope of this segment's service is the laundering and processing of the bed linens, uniforms and other assorted linen items utilized by a client facility. Food, which began operations in 1997, consists of providing for the development of a menu that meets the patient's dietary needs, and the purchasing and preparing of the food for delivery to the patients.

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

Principles of Consolidation

The consolidated financial statements include the accounts of Healthcare Services Group, Inc. and its wholly-owned subsidiaries, HCSG Supply, Inc. and Huntingdon Holdings, Inc. after elimination of intercompany transactions and balances.

Cash and Cash Equivalents

Cash and cash equivalents consist of short-term, highly liquid investments with a maturity of three months or less at time of purchase.

Inventories and Supplies

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.

Property and Equipment

Property and equipment are stated at cost. Additions, renewals and improvements are capitalized, while maintenance and repair costs are expensed when incurred. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the respective accounts and any resulting gain or loss is included in income. Depreciation is provided by the straight-line method over the following estimated useful lives: laundry and linen equipment installations – 3 to 7 years; housekeeping and office equipment – 3 to 7 years; autos and trucks – 3 years.

Revenue Recognition

Revenues from our annual service agreements with clients are recognized as services are performed.

As a distributor of laundry equipment, we occasionally sell laundry installations to certain clients. The sales in most cases represent the construction and installation of a turn-key operation and are for payment terms ranging from 24 to 60 months. Our accounting policy for these sales is to recognize the gross profit over the life of the payments associated with our financing of the transactions. During 2005, 2004 and 2003 laundry installation sales were not material.

Income Taxes

The provision for income taxes has been determined using the asset and liability approach of accounting for income taxes. Under this approach, deferred taxes represent the future tax consequences expected to occur when the reported amounts of assets and liabilities are recovered or paid. The provision for income taxes represents income taxes paid or payable for the current year plus the change in deferred taxes during the year. Deferred taxes result from differences between the financial and tax bases of the Company's assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted.

In accordance with SFAS 109, deferred tax assets should be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. The future realization of our net deferred tax assets depends on the availability of sufficient future taxable income. In making this determination, we considered all available positive and negative evidence and made certain assumptions. We considered, among other things, the overall business environment and our historical earnings. We performed this analysis as of December 31, 2005 and determined that there was sufficient positive evidence to conclude that it is more likely than not that our deferred tax assets will be realized. We will assess the need for a deferred tax asset valuation allowance on an ongoing basis considering factors such as those mentioned above, as well as other relevant criteria.

Earnings per Common Share

Basic earnings per common share is computed by dividing income available to common shareholders by the weighted-average common shares outstanding for the period. Diluted earnings per common share reflects the weighted-average common shares outstanding and dilutive common shares, such as those issuable upon exercise of stock options.

Stock-Based Compensation

At December 31, 2005, we had stock based compensation plans, which are described more fully in Note 4. As permitted by SFAS No. 123, "Accounting for Stock Based Compensation" ("SFAS No. 123"), we account for stock-based compensation arrangements in accordance with provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees". Compensation expense for stock options issued to employees is based on the difference on the date of grant, between the fair market value of our stock and the exercise price of the option. No stock based employee compensation cost is reflected in net income, as all options granted under our plans had an exercise price equal to the market value of the underlying common stock at the date of grant. We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction With Selling, or in Conjunction With Selling Goods or Services". Accordingly, all transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123 to stock based compensation.

	Year Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net Income			
As reported	\$19,096,000	\$14,699,000	\$10,860,000
Deduct:			
Total stock based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(3,735,000)</u>	<u>(1,619,000)</u>	<u>(1,639,000)</u>
Pro forma	<u>\$15,361,000</u>	<u>\$13,080,000</u>	<u>\$ 9,221,000</u>
Basic Earnings Per Common Share			
As reported	\$.71	\$.56	\$.42
Pro forma	\$.57	\$.50	\$.36
Diluted Earnings Per Common Share			
As reported	\$.67	\$.53	\$.41
Pro forma	\$.54	\$.47	\$.35

The fair value of the options granted as reported in the table above was estimated at the date of grant using the Black-Sholes pricing model with the following assumptions: risk free interest rate (2.0% to 7.0%), dividend yield (.4% to 1.45%), expected volatility (35.0% to 37.9%), and weighted average expected life (2.32 years – 5.00 years)

In December 2004, the Financial Accounting Standards Board (the “FASB”) issued a revision of SFAS No 123 (“SFAS No. 123R”). This new statement supersedes APB Opinion No. 25 and its related implementation guidance. SFAS No. 123R requires a public entity to measure the cost of options granted based on the grant-date fair value of the grant award (with limited exceptions). That cost will be recognized over the vesting period of the granted options. This statement is effective as of the first annual reporting period that begins after June 15, 2005. We have adopted the standard on January 1, 2006. The adoption of SFAS 123R is expected to have a material impact, starting in the 2006 fourth quarter, on our consolidated results of operations and financial position. This impact will result from the share based payments of our 2006 Employee Stock Purchase Plan and the stock options expected to be granted during the 2006 fourth quarter. Although such impact is expected to be material, the impact cannot be reasonably estimated because it will depend on certain factors which are not fully known at this time. The options outstanding at December 31, 2005 (including options granted during the 2005 fourth quarter) will not impact 2006 consolidated results of operations and financial position since all option-holders were fully vested in such options at December 31, 2005.

Advertising Costs

Advertising costs are expensed when incurred. For the years ended December 31, 2005, 2004 and 2003, advertising costs were not material.

Long-Lived Assets and Impairment of Long-Lived Assets

Our long-lived assets include property and equipment and costs in excess of fair value of net assets acquired (i.e. goodwill). Costs in excess of fair value of net assets acquired arose from the purchase of another company in 1985 which were being amortized over a 31 year period and is included in other noncurrent assets.

As of January 1, 2002 we adopted SFAS No. 142 “Goodwill and Other Intangible Assets”, which eliminated the amortization of purchased goodwill. Upon adoption of SFAS No. 142, as well as at December 31, 2005 and 2004, we performed an impairment

test of our goodwill (amounting to \$1,612,000 at these dates) and determined that no impairment of the recorded goodwill existed. Under SFAS No. 142, goodwill is tested annually and more frequently if an event occurs which indicates the goodwill may be impaired.

As of January 1, 2002, we adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets" which supersedes SFAS No. 121, "Accounting for the Impairment of Long-lived Assets to be Disposed Of". The adoption of SFAS No. 144 had no effect on the Company.

Treasury Stock

Treasury stock purchases are accounted for under the cost method whereby the entire cost of the acquired stock is recorded as treasury stock. Gains or losses on the subsequent reissuance of shares are credited or charged to additional paid in capital.

Three-for-Two Stock Splits

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. Additionally, on February 12, 2004, our Board of Directors approved a three-for-two stock split in the form of a 50% common stock dividend which was paid on March 1, 2004 to shareholders of record on February 23, 2004. All share and per common share information for all periods presented have been adjusted to reflect the three-for-two stock splits.

Reclassification

Certain prior period amounts have been reclassified to conform to current year presentation.

Use of Estimates in Financial Statements

In preparing financial statements in conformity with generally accepted accounting principles, we make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are used for, but not limited to, our allowance for doubtful accounts, accrued insurance claims and deferred tax benefits. The estimates are based upon various factors including current and historical trends, as well as other pertinent industry and regulatory authority information. We regularly evaluate this information to determine if it is necessary to update the basis for our estimates and to compensate for known changes.

Concentrations of Credit Risk

SFAS No. 105, "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk", requires the disclosure of significant concentrations of credit risk, regardless of the degree of such risk. Financial instruments, as defined by SFAS No. 105, which potentially subject us to concentrations of credit risk, consist principally of cash and cash equivalents and accounts and notes receivable. At December 31, 2005 and 2004, substantially all of our cash and cash equivalents were invested with one large financial institution located in the United States.

Our clients are concentrated in the health care industry, primarily providers of long-term care. Many of our clients' revenues are highly contingent on Medicare and Medicaid reimbursement funding rates, which have been and continue to be adversely affected by the change in Medicare payments under the 1997 enactment of the Prospective Payment System. That change and lack of substantive reimbursement funding rate reform legislation, as well as other trends in the long-term care industry have resulted in certain of our clients filing for bankruptcy protection. Others may follow. Any decisions by the government to discontinue or adversely modify legislation related to reimbursement funding rates will have a material adverse affect on our clients. These factors, in addition to delays in payments from clients, have resulted in, and could continue to result in, significant additional bad debts in the near future.

Major Client

We have one client, a nursing home chain, which due to its significant contribution to our total revenues, we consider a major client. Such client's percentage contribution to revenues and accounts receivable balances is summarized below:

	<u>Total Revenues</u>	<u>Reportable Segments Revenues</u> <u>Housekeeping</u>	<u>Food</u>	<u>Amounts due at December 31,</u> <u>% of accounts receivable balance</u>
2005	19%	18%	27%	less than 1%
2004	20%	19%	27%	less than 1%
2003	23%	23%	22%	less than 1%

According to public filings, the client entered into a merger agreement on August 16, 2005 and the transaction is expected to close in the first quarter of 2006. Although we expect to continue our relationship with this client's successor, there can be no assurance thereof, and the loss of such client would have a material adverse effect on our results of operations of our two operating segments. Additionally, if such client's successor changes its payment terms, it would increase our accounts receivable balance and have a material adverse effect on our cash flows and cash and cash equivalents.

Fair Value of Financial Instruments

The carrying value of financial instruments (principally consisting of cash and cash equivalents, accounts and notes receivable and accounts payable) approximate fair value based on their short-term nature. We estimate the fair value of our other financial instruments through the use of public market prices, quotes from financial institutions and other available information.

We have certain notes receivable that do not bear interest. Therefore, such notes receivable of \$3,365,000 and \$3,984,000 at December 31, 2005 and 2004, respectively, have been discounted to their present value and are reported at such values of \$2,288,000 and \$2,855,000 at December 31, 2005 and 2004, respectively.

Recent Accounting Pronouncements

In December 2004, the FASB issued a revision of Financial Accounting Standards No. 123 ("SFAS 123R") which requires all share-based payments to employees to be recognized in the income statement based on their fair values. Our option grants to employees, non-employees and directors, as well as common stock shares issued pursuant to our Employee Stock Purchase Plan will represent share-based payments.

As permitted by Statement 123, we currently account for share-based payments to employees in accordance with APB No. 25. We expect to calculate the fair value of share-based payments under SFAS 123R on a basis substantially consistent with the fair value approach of SFAS 123. We have adopted SFAS 123R in our fiscal year beginning January 1, 2006. The adoption of SFAS 123R is expected to have a material impact, starting in the 2006 fourth quarter, on our consolidated results of operations and financial position. This impact will result from the share based payments under our 2006 Employee Stock Purchase Plan and the stock options expected to be granted during the 2006 fourth quarter. Although such impact is expected to be material, the impact cannot be reasonably estimated because it will depend on certain factors which are not fully known at this time. The options outstanding at December 31, 2005 (including options granted during the 2005 fourth quarter) will not impact 2006 consolidated results of operations and financial position since all option-holders were fully vested in such options at December 31, 2005.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3." This statement will be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this statement was issued. This statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or

the cumulative effect of the change. The Company does not anticipate that the adoption of this statement will have a material impact on our consolidated results of operations or financial condition.

Note 2—Allowance for Doubtful Accounts

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

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

We have had varying collection experience with respect to our accounts and notes receivable. When contractual terms are not met, we generally encounter difficulty in collecting amounts due from certain of our clients. Therefore, we have sometimes been required to extend the period of payment for certain clients beyond contractual terms. These clients have included 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 \$1,425,000, \$3,700,000 and \$4,550,000 in the years ended December 31, 2005, 2004 and 2003, respectively. In making our 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. Notwithstanding our efforts to minimize our 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. In the event that our clients experience such significant impact in their cash flows, it would have a material adverse effect on our results of operations and financial condition.

Impaired Notes Receivable

We evaluate our notes receivable for impairment quarterly and on an individual client basis. Notes receivable considered impaired are generally attributable to clients that are either in bankruptcy, are subject to collection activity or those slow payers that are experiencing financial difficulties. In the event that a note receivable is impaired, it is accounted for in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114 and SFAS No. 118; that is, it is valued at the present value of expected cash flows or market value of related collateral.

At December 31, 2005, 2004 and 2003, we had notes receivable aggregating \$2,500,000, \$2,500,000 and \$3,900,000, respectively, that are impaired. During 2005, 2004 and 2003, the average outstanding balance of impaired notes receivable was \$2,500,000, \$3,200,000 and \$4,800,000, respectively. No interest income was recognized in any of these years.

Summary schedules of impaired notes receivable, and the related reserve, for the years ended December 31, 2005, 2004 and 2003 are as follows:

Impaired Notes Receivable				
	Balance Beginning of Year	Additions	Deductions	Balance End of Year
2005	\$2,500,000	\$ 60,000	\$ 60,000	\$2,500,000
2004	\$3,900,000	\$1,600,000	\$3,000,000	\$2,500,000
2003	\$5,800,000	\$ 100,000	\$2,000,000	\$3,900,000

Reserve for Impaired Notes Receivable				
	Balance Beginning of Year	Additions	Deductions	Balance End of Year
2005	\$ 500,000	\$ 900,000	\$ 100,000	\$1,300,000
2004	\$1,900,000	\$1,300,000	\$2,700,000	\$ 500,000
2003	\$2,500,000	\$1,250,000	\$1,850,000	\$1,900,000

We follow an income recognition policy on notes receivable that does not recognize interest income until cash payments are received. This policy was established for conservative reasons, recognizing the environment of the long-term care industry, and not because such notes receivable are impaired. The difference between income recognition on a full accrual basis and cash basis, for notes receivable that are not considered impaired, is not material. For impaired notes receivable, interest income is recognized on a cost recovery basis only.

Note 3—Lease Commitments

We lease office facilities, equipment and autos under operating leases expiring on various dates through 2010. Certain office leases contain renewal options. The following is a schedule, by calendar year, of future minimum lease payments under operating leases that have remaining terms in excess of one year as of December 31, 2005.

Year	Operating Leases
2006	\$ 982,000
2007	812,000
2008	565,000
2009	419,000
2010	339,000
Thereafter	—
Total minimum lease payments	\$3,117,000

Total expense for all operating leases was approximately \$913,000, \$973,000 and \$961,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

Note 4—Stockholders' Equity

The Nominating, Compensation and Stock Option Committee of the Board of Directors is responsible for determining the individuals who will be granted options, the number of options each individual will receive, the option price per share, and the exercise period of each option.

We have granted incentive and non-qualified stock options primarily to employees and directors under either our 2002 Stock Option Plan, 1995 Incentive and Non-Qualified Stock Option Plan for key employees or 1996 Non-Employee Director's Stock Option Plan. On April 19, 2005, our Board of Directors adopted an Amendment to the 2002 Stock Option Plan to increase the total number of shares of our Common Stock available for issuance under such Plan from 2,363,000 to 3,863,000. Such Amendment was approved by shareholders on May 24, 2005. On April 22, 2003, our Board of Directors adopted an Amendment to the 2002 Stock Option Plan. Such Amendment was approved by shareholders on May 27, 2003. The Amendment increased the total number of shares of our Common Stock available for issuance under such Plan from 1,125,000 shares to 2,363,000. On March 28, 2002, our Board of Directors adopted the 2002 Stock Option Plan. It was approved by shareholders on May 21, 2002.

Incentive Stock Options

As of December 31, 2005, 3,084,000 shares of common stock were reserved under our incentive stock option plans, including 1,555,000 shares which are available for future grant. The incentive stock option price will not be less than the fair market value of the common stock on the date the option is granted. No option grant will have a term in excess of ten years. Additionally, options granted vest and become exercisable either on the date of grant or commencing six months from the option grant date.

A summary of incentive stock option activity is as follows:

	2005		2004		2003	
	Weighted Average Price	Number Of Shares	Weighted Average Price	Number of Shares	Weighted Average Price	Number of Shares
Beginning of period	\$ 7.35	1,969,000	\$ 5.26	2,206,000	\$3.90	2,253,000
Granted	20.71	318,000	13.65	468,000	8.29	648,000
Cancelled	5.42	(55,000)	7.52	(30,000)	4.39	(5,000)
Exercised	6.93	(703,000)	4.86	(675,000)	3.67	(690,000)
End of period	<u>\$10.40</u>	<u>1,529,000</u>	<u>\$ 7.35</u>	<u>1,969,000</u>	<u>\$5.26</u>	<u>2,206,000</u>

The weighted average fair value of incentive stock options granted during 2005, 2004 and 2003 was \$4.99, \$3.47 and \$1.85, respectively.

The following table summarizes information about incentive stock options outstanding at December 31, 2005.

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	267,000	3.85	\$ 3.00	267,000	\$ 3.00
\$ 4.11 – 5.62	338,000	6.54	4.98	338,000	4.98
\$ 8.29 – 8.29	269,000	7.99	8.29	269,000	8.29
\$13.65 – 20.71	655,000	7.05	17.09	655,000	17.09
	<u>1,529,000</u>	<u>6.54</u>	<u>\$10.40</u>	<u>1,529,000</u>	<u>\$10.40</u>

Non-Qualified Options

As of December 31, 2005, 1,481,000 shares of common stock were reserved under our non-qualified stock option plans, including 167,000 shares which are available for future grant. Pursuant to the terms of the 1996 Non-Employee Director's Stock Option Plan, each eligible non-employee director receives an automatic grant based on a prescribed formula on the fixed annual grant date. The non-qualified options were granted at option prices which were not less than the fair market value of the common stock on the date the options were granted. The options are exercisable over a five to ten year period, either on the date of grant or commencing six months from the option date.

A summary of non-qualified stock option activity is as follows.

	2005		2004		2003	
	Weighted Average Price	Number Of Shares	Weighted Average Price	Number of Shares	Weighted Average Price	Number of Shares
Beginning of period	\$ 5.63	1,417,000	\$ 4.52	1,438,000	\$3.85	1,313,000
Granted	20.71	108,000	13.65	157,000	8.29	214,000
Cancelled	—	—	—	—	—	—
Exercised	3.67	(211,000)	3.78	(178,000)	3.63	(89,000)
End of period	<u>\$ 7.18</u>	<u>1,314,000</u>	<u>\$ 5.63</u>	<u>1,417,000</u>	<u>\$4.52</u>	<u>1,438,000</u>

The weighted average fair value of non-qualified options granted during 2005, 2004 and 2003 were \$7.08, \$4.49 and \$2.53, respectively.

The following table summarizes information about non-qualified stock options outstanding at December 31, 2005.

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	295,000	3.73	\$ 3.17	295,000	\$ 3.17
\$ 4.09 – 5.62	562,000	6.02	4.50	562,000	4.50
\$8.29 – 8.29	193,000	8.00	8.29	193,000	8.29
\$13.65 – 20.71	<u>264,000</u>	<u>7.36</u>	<u>16.53</u>	<u>264,000</u>	<u>16.53</u>
	<u>1,314,000</u>	<u>6.07</u>	<u>\$ 7.18</u>	<u>1,314,000</u>	<u>\$ 7.18</u>

Fair Value Valuation Estimates

As discussed in Note 1, we apply APB Opinion 25 in measuring stock-based compensation. Accordingly, no compensation cost has been recorded for options granted to employees or directors in the years ended December 31, 2005, 2004 and 2003. The fair value of each option granted has been estimated on the grant date using the Black-Scholes Option Valuation Model. The following assumptions were made in estimating fair value:

	2005	2004	2003
Risk-Free Interest-Rate	7.00%	3.00%	2.00%
Weighted Average Expected Life –			
Incentive Options	2.32 years	2.65 years	2.34 years
Non-Qualified Options	4.20 years	4.46 years	5.00 years
Expected Volatility	35.0%	35.0%	37.9%
Dividend Yield	1.45%	1.25%	1.6%

Dividends

We have paid regular quarterly cash dividends since the second quarter of 2003. During 2005, we paid regular quarterly cash dividends totaling \$8,076,000 as detailed below.

2005 Cash Dividend Payments	<u>1st Quarter</u>	<u>2nd Quarter</u>	<u>3rd Quarter</u>	<u>4th Quarter</u>
Cash dividend per common share	\$.06	\$.07	\$.08	\$.09
Payment date	February 11	May 16	August 12	November 14
Record date	January 28	May 4	July 29	October 31

On January 24, 2006, our Board of Directors declared a regular quarterly cash dividend of \$.10 per common share, which was paid on February 13, 2006 to shareholders of record as of February 3, 2006.

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.

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. Additionally, on February 12, 2004, our Board of Directors approved a three-for-two stock split in the form of a 50% common stock dividend which was paid on March 1, 2004 to shareholders of record on February 23, 2004. The effect of these actions was to increase common shares outstanding by 9,345,000 to 28,036,000 and 5,980,000 to 17,950,000 in 2005 and 2004, respectively. All share and per common share information for all periods presented have been adjusted to reflect the three-for-two stock splits.

Note 5—Income Taxes

The following table summarizes the provision for income taxes.

	Year Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current:			
Federal	\$ 9,732,000	\$7,687,000	\$5,095,000
State	<u>2,370,000</u>	<u>2,306,000</u>	<u>1,734,000</u>
	12,102,000	9,993,000	6,829,000
Deferred:			
Federal	(504,000)	(814,000)	(99,000)
State	<u>105,000</u>	<u>(172,000)</u>	<u>(75,000)</u>
	<u>(399,000)</u>	<u>(986,000)</u>	<u>(174,000)</u>
Tax Provision	<u>\$11,703,000</u>	<u>\$9,007,000</u>	<u>\$6,655,000</u>

Significant components of our federal and state deferred tax assets and liabilities are as follows:

	Year Ended December 31,	
	<u>2005</u>	<u>2004</u>
Net current deferred assets:		
Allowance for doubtful accounts	\$ 915,000	\$ 765,000
Accrued insurance claims- current	1,771,000	1,705,000
Expensing of housekeeping supplies	(2,074,000)	(2,013,000)
Other	<u>(257,000)</u>	<u>117,000</u>
	<u>\$ 355,000</u>	<u>\$ 574,000</u>
Net noncurrent deferred tax assets:		
Deferred compensation	\$ 2,364,000	\$ 1,883,000
Non-deductible reserves	433,000	462,000
Depreciation of property and equipment	(822,000)	(1,077,000)
Accrued insurance claims- noncurrent	4,132,000	4,183,000
Other	<u>74,000</u>	<u>112,000</u>
	<u>\$ 6,181,000</u>	<u>\$ 5,563,000</u>

A reconciliation of the provision for income taxes and the amount computed by applying the statutory federal income tax rate to income before income taxes is as follows:

	Year Ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Tax expense computed at statutory rate	\$10,779,000	\$8,297,000	\$5,955,000
Increases (decreases) resulting from:			
State income taxes, net of federal tax benefit	1,576,000	1,386,000	1,128,000
Federal jobs credits	(524,000)	(641,000)	(578,000)
Tax exempt interest	(243,000)	(102,000)	(73,000)
Other, net	<u>115,000</u>	<u>67,000</u>	<u>223,000</u>
	<u>\$11,703,000</u>	<u>\$9,007,000</u>	<u>\$6,655,000</u>

Income taxes paid were \$8,196,000, \$7,256,000 and \$4,728,000 during 2005, 2004 and 2003, respectively.

Note 6—Related Party Transactions

One of our directors, as well as the brother of an officer and director (collectively “Related Parties”), have separate ownership interests in several different client facilities which have entered into service agreements with us. During the years ended December 31, 2005, 2004 and 2003 the service agreements with the client facilities in which the Related Parties have ownership interests resulted in revenues of \$7,652,000, \$6,608,000 and \$4,265,000, respectively. At December 31, 2005 and 2004, accounts and notes receivable from such facilities of \$2,343,000 and \$1,633,000, respectively, are included in the accompanying consolidated balance sheets. During 2005, we encountered difficulty in collecting amounts due from facilities operated by the brother of an officer and director. We were issued interest bearing promissory notes in the aggregate amount of \$1,200,000 for the obligations

due. At December 31, 2005, the subject accounts and notes receivable balances due from the Related Parties are within agreed upon payment terms.

Another of our directors is a member of a law firm which was retained by us during the years ended December 31, 2005, 2004 and 2003. Fees received from us by such firm did not exceed \$100,000 in any of the years ended December 31, 2005, 2004 and 2003. Additionally, such fees did not exceed, in any year, 5% of such firm's revenues.

Note 7—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 disclosed 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 services	Food services	Corporate and eliminations	Total
Year Ended December 31, 2005				
Revenues	\$375,133,000	\$92,864,000	\$ (1,706,000)	\$466,291,000
Income before income taxes	31,909,000	2,634,000	(3,744,000) ⁽¹⁾	30,799,000
Depreciation	1,229,000	116,000	527,000	1,872,000
Total assets	62,631,000	17,754,000	108,045,000 ⁽²⁾	188,430,000
Year Ended December 31, 2004				
Revenues	\$357,754,000	\$87,309,000	\$ (2,495,000)	\$442,568,000
Income before income taxes	29,336,000	1,934,000	(7,564,000) ⁽¹⁾	23,706,000
Depreciation	1,191,000	97,000	585,000	1,873,000
Total assets	60,958,000	15,546,000	90,460,000 ⁽²⁾	166,964,000
Year Ended December 31, 2003				
Revenues	\$318,540,000	\$62,189,000	\$ (1,010,000)	\$379,718,000
Income before income taxes	23,361,000	1,964,000	(7,811,000) ⁽¹⁾	17,515,000
Depreciation	1,159,000	69,000	687,000	1,915,000
Total assets	65,045,000	14,789,000	78,494,000 ⁽²⁾	158,328,000

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

(2) represents primarily cash and cash equivalents, deferred income taxes and other current and noncurrent assets.

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:

	Year Ended December 31,		
	2005	2004	2003
Housekeeping services	\$262,842,000	\$249,314,000	\$223,303,000
Laundry and linen services	109,764,000	105,545,000	93,257,000
Food services	91,244,000	85,593,000	61,677,000
Maintenance services and Other	2,441,000	2,116,000	1,481,000
	\$466,291,000	\$442,568,000	\$379,718,000

Major Client

We have one client, a nursing home chain, which in 2005, 2004 and 2003 accounted for 19%, 20% and 23%, respectively, of total revenues. In the year ended December 31, 2005, we derived 18% and 27%, respectively, of the Housekeeping and Food segments' revenues from such client. Additionally, at both December 31, 2005 and 2004, amounts due from such client represented less than 1% of our accounts receivable balance. According to public filings, the client entered into a merger agreement on August 16, 2005 and the transaction is expected to close in the first quarter of 2006. Although we expect to continue the relationship with this client's successor, there can be no assurance thereof, and the loss of such client would have a material adverse affect on the results of operations of our two operating segments. In addition, if such client's successor changes its payment terms it would increase our accounts receivable balance and have a material adverse effect on our cash flows and cash and cash equivalents.

Note 8—Earnings Per Common Share

A reconciliation of the numerators and denominators of basic and diluted earning per common share is as follows:

	Year Ended December 31, 2005		
	Income (Numerator)	Shares (Denominator)	Per-share Amount
Net Income	<u>\$19,096,000</u>		
Basic earnings per common share	19,096,000	26,921,000	\$.71
Effect of dilutive securities:			
Options		<u>1,399,000</u>	<u>(.04)</u>
Diluted earnings per common share	<u>\$19,096,000</u>	<u>28,320,000</u>	<u>\$.67</u>

	Year Ended December 31, 2004		
	Income (Numerator)	Shares (Denominator)	Per-share Amount
Net Income	<u>\$14,699,000</u>		
Basic earnings per common share	14,699,000	26,221,000	\$.56
Effect of dilutive securities:			
Options		<u>1,439,000</u>	<u>(.03)</u>
Diluted earnings per common share	<u>\$14,699,000</u>	<u>27,660,000</u>	<u>\$.53</u>

	Year Ended December 31, 2003		
	Income (Numerator)	Shares (Denominator)	Per-share Amount
Net Income	<u>\$10,860,000</u>		
Basic earnings per common share	10,860,000	25,574,000	\$.42
Effect of dilutive securities:			
Options		<u>1,108,000</u>	<u>(.01)</u>
Diluted earnings per common share	<u>\$10,860,000</u>	<u>26,682,000</u>	<u>\$.41</u>

No outstanding options were excluded from the computation of diluted earnings per common share for the years ended December 31, 2005, 2004 and 2003 as none have an exercise price in excess of the average market value of our common stock during such periods.

Note 9—Other Contingencies

We have a \$25,000,000 bank line of credit on which we may draw to meet short-term liquidity requirements in excess of internally generated cash flow. Amounts drawn under the line of credit are payable upon demand. At December 31, 2005 there were no borrowings under the line of credit. However, at such date, we had outstanding a \$17,925,000 (increased to \$23,925,000 on January 1, 2006) irrevocable standby letter of credit which relates 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 \$17,925,000 at December 31, 2005. The line of credit requires us to satisfy two financial covenants. We are in compliance with the financial covenants at December 31, 2005 and expect to continue to remain in compliance with such financial covenants.

We provide our services in 45 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.

As of December 31, 2005 and December 31, 2004 we have unsettled tax assessments (including interest to date) from various state taxing authorities of \$550,000 (\$358,000, net of federal income taxes) and \$2,800,000 (\$1,800,000, net of federal income taxes), respectively. With respect to these assessments, we have recorded a reserve at December 31, 2005 of \$155,000 (\$100,000, net of federal income taxes) and at December 31, 2004 of \$900,000 (\$590,000, net of federal income taxes). During 2005, we executed a closing agreement with a state's revenue services department settling a \$2,400,000 assessment (including interest) resulting from the state's audit of our sales and use tax filings for the period July 1, 1999 through June 30, 2003. The closing agreement settlement, among other understandings, required a payment of \$700,000 (including interest) in connection with the audit assessment. Such payment was charged to the aforementioned reserve.

With respect to the other remaining outstanding assessments, we intend to vigorously defend our positions that the assessments are without merit. 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 effect on our consolidated financial position or results of operations.

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

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

Note 10—Accrued Insurance Claims

We currently have a Paid Loss Retrospective Insurance Plan for general liability and workers' compensation insurance. Under these plans, 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 consolidated results of operations and financial condition.

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 accrued insurance claims were reduced by approximately \$903,000, \$935,000 and \$1,287,000 at December 31, 2005, 2004 and 2003, respectively in order to record the estimated present value at the end of each year using an 8% discount factor over the estimated remaining pay-out period.

For general liability, we record a reserve for the estimated amounts to be paid for known claims.

Note 11—Employee Benefit Plans

Employee Stock Purchase Plan

Since January 1, 2000, we have had a non-compensatory Employee Stock Purchase Plan (“the ESPP”) for all eligible employees. All full-time and certain part-time employees who have completed two years of continuous service with us are eligible to participate. The ESPP was implemented through four annual offerings. The first annual offering commenced on January 1, 2000. On February 12, 2004 (effective January 1, 2004), our Board of Directors extended the ESPP for an additional eight annual offerings. Annual offerings commence and terminate on the respective year’s first and last calendar day. Under the ESPP, we are authorized to issue up to 1,800,000 shares of our common stock to our employees. Furthermore, under the terms of the ESPP, eligible employees can choose each year to have up to \$25,000 of their annual earnings withheld to purchase our Common Stock. The purchase price of the stock is 85% of the lower of its beginning or end of the plan year market price.

The following table summarizes information about our ESPP annual offerings for the years ended December 31, 2005, 2004 and 2003:

	ESPP Annual Offering		
	2005	2004	2003
Common shares purchased	64,000	90,000	72,000
Per common share purchase price	\$11.32	\$7.17	\$5.06
Common shares date of issue	January 9, 2006	January 10, 2005	January 9, 2004

Retirement Savings Plan

Since October 1, 1999, we have had a retirement savings plan for non-highly compensated employees (the “RSP”) under Section 401(k) of the Internal Revenue Code. The RSP allows eligible employees to contribute up to fifteen percent (15%) of their eligible compensation on a pre-tax basis. There is no match by the Company.

Deferred Compensation Plan

Since January 1, 2000, we have had a Supplemental Executive Retirement Plan (the “SERP”) for certain key executives and employees. The SERP is not qualified under section 401 of the Internal Revenue Code. Under the SERP, participants may defer up to 15% of their earned income on a pre-tax basis. As of the last day of each plan year, each participant will receive a 25% match of their deferral in our Common Stock based on the then current market value. SERP participants fully vest in our matching contribution three years from the first day of the initial year of participation. The income deferred and our matching contribution are unsecured and subject to the claims of our general creditors. In the aggregate, since initiation of the SERP, 148,000 shares (including the 2005 funding of shares delivered in 2006) held by the trustee are accounted for at cost, as treasury stock. At December 31, 2005, 116,000 of such shares are vested in the respective participants’ accounts.

The following table summarizes information about our SERP for the plan years ended December 31, 2005, 2004 and 2003:

	SERP Plan Year		
	2005	2004	2003
Amount expensed under SERP	\$ 317,000	\$ 280,000	\$ 238,000
Treasury shares issued to fund SERP expense	15,000	20,000	29,000
SERP trust account balance at December 31	\$5,626,000(1)	\$4,062,000(1)	\$2,848,000(1)
Unrealized gains recorded in SERP trust account	\$ 705,000	\$ 336,000	\$ 418,000

(1) SERP trust account investments are recorded at their fair value which is based on quoted market prices.

Note 12—Selected Quarterly Financial Data (Unaudited)

	Three Months Ended			
	<u>March 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
2005				
Revenues	\$114,695,000	\$116,048,000	\$117,684,000	\$117,864,000
Operating costs and expenses	\$108,199,000	\$109,494,000	\$110,908,000	\$110,089,000
Income before income taxes	\$ 6,876,000	\$ 7,393,000	\$ 7,699,000	8,831,000
Net income	\$ 4,263,000	\$ 4,584,000	\$ 4,774,000	5,475,000
Basic earnings per common share ¹	\$.16	\$.17	\$.18	\$.20
Diluted earnings per common share ¹	\$.15	\$.16	\$.17	\$.19
Cash dividends per common share ¹	\$.06	\$.07	\$.08	\$.09
2004				
Revenues	\$106,622,000	\$110,489,000	\$112,324,000	\$113,133,000
Operating costs and expenses	\$101,412,000	\$105,101,000	\$106,611,000	\$107,067,000
Income before income taxes	\$ 5,352,000	\$ 5,694,000	\$ 6,006,000	\$ 6,654,000
Net income	\$ 3,318,000	\$ 3,530,000	\$ 3,724,000	\$ 4,127,000
Basic earnings per common share ¹	\$.13	\$.13	\$.14	\$.16
Diluted earnings per common share ¹	\$.12	\$.13	\$.13	\$.15
Cash dividends per common share ¹	\$.03	\$.04	\$.05	\$.05

¹ Year-to-date earnings and cash dividends per common share amounts may differ from the sum of quarterly amounts due to rounding.

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Healthcare Services Group, Inc., is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is defined in Rule 13a-15(f) and 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of The Company's financial statements for external purposes in accordance with generally accepted accounting principles in the United States and includes those policies and procedures that:

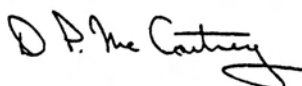
1. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets of the Company;
2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the company; and
3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of the end of December 31, 2005. In making this assessment, the Company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control-Integrated Framework.

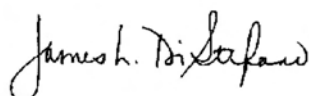
Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our internal control over financial reporting, as prescribed above, for the periods covered by this report. Based on our evaluation, our principal executive officer and principal financial officer concluded that the Company's internal control over financial reporting as of December 31, 2005 is effective.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's independent auditors have attested to, and reported on, management's evaluation of the company's internal control over financial reporting as of December 31, 2005. This report appears on page 44.



Daniel P. McCartney
Chief Executive Officer
February 14, 2006



James L. DiStefano
Chief Financial Officer
February 14, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Stockholders and Board of Directors
Healthcare Services Group, Inc.

We have audited the accompanying consolidated balance sheets of Healthcare Services Group, Inc. and Subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, cash flows, and stockholders' equity for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Healthcare Services Group, Inc. and Subsidiaries at December 31, 2005 and 2004 and the consolidated results of their operations and their consolidated cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Oversight Board (United States), the effectiveness of Healthcare Services Group, Inc's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 14, 2006 expressed an unqualified opinion thereon.



Edison, New Jersey

February 14, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Stockholders and Board of Directors
Healthcare Services Group, Inc.

We have audited management's assessment, included in the accompanying Management Report on Internal Control Over Financial Reporting, that Healthcare Services Group, Inc. and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Healthcare Services Group, Inc. and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2005 and 2004, and the related consolidated statements of income, cash flows, and stockholders' equity, for each of the three years in the period ended December 31, 2005, and our report dated February 14, 2006 expressed an unqualified opinion thereon.



Edison, New Jersey

February 14, 2006

Transfer Agent

American Stock Transfer & Trust Co.
99 Wall St.
New York, NY 10005

Auditors

Grant Thornton LLP
399 Thornall Street
Edison, NJ 08837

Directors

Daniel P. McCartney
Chairman & Chief Executive Officer

Thomas A. Cook
President & Chief Operating Officer

Joseph F. McCartney
Northeast Divisional Vice President

Officers and Corporate Management

Daniel P. McCartney
Chief Executive Officer

Thomas A. Cook
President & Chief Operating Officer

Frank Bennett
Food Service Divisional
Vice President

James L. DiStefano
Chief Financial Officer & Treasurer

Michael Hammond
Western Regional Vice President

Michael Harder
Vice President - Credit Administration

Richard W. Hudson
Vice President - Finance and Secretary

Market Makers

As of the end of 2005, the following firms were making a market in the shares of Healthcare Services Group, Inc.:

UBS Capital Markets, L.P.
Goldman, Sachs & Co.
Jefferies & Company, Inc.
Lehman Bros. Inc.

Corporate Offices

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Corporate Counsel

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Barton D. Weisman
Chairman-NuVision Management, LLC

Robert L. Frome, Esq.
Senior Partner - Olshan Grundman Frome
Rosenzweig & Wolosky LLP

Robert J. Moss, Esq.
President - Moss Associates

John D. Kelly
Western Divisional Vice President

Gerrod Lambrecht
Midwest Divisional Vice President

Nicholas R. Marino
Human Resources Director

Michael E. McBryan
Senior Vice President

Bryan D. McCartney
Senior Vice President

Joseph F. McCartney
Northeast Divisional Vice President

Kevin McCartney
Northeast Divisional Vice President

Stock Listing

Listed on the NASDAQ
National Market System Symbol - "HCSG"

Annual Stockholders' Meeting

Date - May 23, 2006

Time - 10:00 A.M.

Place - The Radisson Hotel of Bucks County
2400 Old Lincoln Highway
Trevose, PA 19047

John M. Briggs
Certified Public Accountant

James Schreck
Midwest Divisional Vice President

Robert Scutta
Mid-Atlantic Divisional Vice President

David Smigel
Western Divisional Vice President

James P. O'Toole
Mid-Atlantic Divisional Vice President

Brian M. Waters
Southeast Divisional Vice President

ABOUT YOUR SHARES

Healthcare Services Group, Inc.'s Common Stock is traded on the NASDAQ National Market System of the over-the-counter market. On December 31, 2005 there were 27,062,000 of the Company's common shares issued and outstanding. As of February 14, 2006 there were 691 holders of record of the common stock, including holders whose stock was held in nominee name by brokers or other nominees. It is estimated that there are Xxx beneficial holders.

The high and low closing price quotations for our Common Stock during the years ended December 31, 2005 and 2004, ranged as follows (adjusted to reflect the 3 for 2 stock split paid in the form of a 50% common stock dividend on May 2, 2005):

	<u>2005 High</u>	<u>2005 Low</u>	<u>2004 High</u>	<u>2004 Low</u>
1st Qtr.	\$16.53	\$12.54	\$11.33	\$ 8.44
2nd Qtr.	20.65	14.17	11.23	9.86
3rd Qtr.	21.60	15.77	12.41	10.13
4th Qtr.	21.45	17.01	14.27	11.69

Availability of Form 10-K

A copy of Healthcare Services Group, Inc.'s 2005 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission is available on the Company's website "www.hcsgcorp.com". Additionally, it will be provided without charge to each shareholder making a written request to the Investor Relations Department of the Company at its Corporate Offices.

