

SUNLINK HEALTH SYSTEMS INC
Form 10-Q
May 15, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number 1-12607

SUNLINK HEALTH SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Ohio
(State or other jurisdiction of incorporation)

31-0621189
(I.R.S. Employer

or organization)

Identification No.)

900 Circle 75 Parkway, Suite 1120, Atlanta, Georgia 30339

(Address of principal executive offices)

(Zip Code)

(770) 933-7000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filings requirements for the past 90 days. Yes No

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

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Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of Common Shares, without par value, outstanding as of May 14, 2007 was 7,509,534.

PART I. FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)

(unaudited)

| | March 31, 2007 | June 30, 2006 |
|---|-------------------|------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 834 | \$ 1,084 |
| Receivables - net | 16,244 | 16,494 |
| Medical supplies | 2,725 | 2,577 |
| Deferred income tax asset | 4,875 | 5,391 |
| Prepaid expenses and other | 3,372 | 2,363 |
| Total Current Assets | 28,050 | 27,909 |
| Property, Plant and Equipment, at cost | 58,689 | 51,800 |
| Less accumulated depreciation and amortization | 13,700 | 10,645 |
| Property, Plant and Equipment - net | 44,989 | 41,155 |
| Goodwill | 2,944 | 2,944 |
| Other assets | 2,524 | 2,295 |
| Total Assets | \$ 78,507 | \$ 74,303 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 8,318 | \$ 7,689 |
| Revolving advances | 4,400 | |
| Third-party payor settlements | 4,254 | 3,666 |
| Current maturities of long-term debt | 868 | 928 |
| Accrued payroll and related taxes | 5,346 | 5,231 |
| Income taxes | 634 | 211 |
| Current liabilities of Mountainside Medical Center | 597 | 1,528 |
| Other accrued expenses | 3,409 | 3,042 |
| Total Current Liabilities | 27,826 | 22,295 |
| Long-Term Liabilities: | | |
| Long-term debt | 7,827 | 8,465 |
| Noncurrent liability for professional liability risks | 2,393 | 3,281 |
| Noncurrent deferred income tax liabilities | 3,046 | 4,025 |
| Other noncurrent liabilities | 2,126 | 1,885 |
| Total Long-term Liabilities | 15,392 | 17,656 |
| Commitments and Contingencies | | |
| Shareholders' Equity: | | |
| Preferred shares, authorized and unissued, 2,000 shares Common shares, without par value: | | |

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| | | |
|--|------------------|------------------|
| Issued and outstanding, 7,503 shares at March 31, 2007 and 7,315 shares at June 30, 2006 | 3,752 | 3,658 |
| Additional paid-in capital | 8,787 | 8,393 |
| Retained earnings | 23,060 | 22,545 |
| Accumulated other comprehensive loss | (310) | (244) |
| Total Shareholders' Equity | 35,289 | 34,352 |
| Total Liabilities and Shareholders' Equity | \$ 78,507 | \$ 74,303 |

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share amounts)

(unaudited)

| | THREE MONTHS ENDED MARCH 31, | | NINE MONTHS ENDED MARCH 31, | |
|---|---------------------------------|-----------|--------------------------------|------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net Revenues | \$ 37,490 | \$ 34,630 | \$ 106,049 | \$ 100,771 |
| Cost of Patient Service Revenues: | | | | |
| Salaries, wages and benefits | 17,818 | 17,150 | 52,911 | 49,496 |
| Provision for bad debts | 5,519 | 3,307 | 14,700 | 10,694 |
| Supplies | 4,151 | 3,583 | 11,940 | 10,734 |
| Purchased services | 2,268 | 2,159 | 6,671 | 6,391 |
| Other operating expenses | 4,411 | 5,023 | 12,274 | 13,375 |
| Rent and lease expense | 661 | 597 | 2,075 | 1,819 |
| Depreciation and amortization | 1,089 | 866 | 3,219 | 2,418 |
| Cost of patient service revenues | 35,917 | 32,685 | 103,790 | 94,927 |
| Operating Profit | 1,573 | 1,945 | 2,259 | 5,844 |
| Other Income (Expense): | | | | |
| Interest expense | (368) | (285) | (1,018) | (846) |
| Interest income | 6 | 8 | 21 | 47 |
| Earnings from Continuing Operations before Income Taxes | 1,211 | 1,668 | 1,262 | 5,045 |
| Income Tax Expense | 599 | 659 | 645 | 2,035 |
| Earnings from Continuing Operations | 612 | 1,009 | 617 | 3,010 |
| Loss from Discontinued Operations | (153) | (377) | (102) | (373) |
| Net Earnings | \$ 459 | \$ 632 | \$ 515 | \$ 2,637 |
| Earnings (Loss) Per Share: | | | | |
| Continuing Operations: | | | | |
| Basic | \$ 0.08 | \$ 0.14 | \$ 0.08 | \$ 0.42 |
| Diluted | \$ 0.08 | \$ 0.13 | \$ 0.08 | \$ 0.38 |
| Discontinued Operations: | | | | |
| Basic | \$ (0.02) | \$ (0.05) | \$ (0.01) | \$ (0.05) |
| Diluted | \$ (0.02) | \$ (0.05) | \$ (0.01) | \$ (0.05) |
| Net Earnings : | | | | |
| Basic | \$ 0.06 | \$ 0.09 | \$ 0.07 | \$ 0.36 |
| Diluted | \$ 0.06 | 0.08 | 0.07 | \$ 0.34 |
| Weighted-Average Common Shares Outstanding: | | | | |
| Basic | 7,403 | 7,269 | 7,359 | 7,238 |

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| | | | | |
|---------|-------|-------|-------|-------|
| Diluted | 7,790 | 7,890 | 7,811 | 7,847 |
|---------|-------|-------|-------|-------|

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

| | NINE MONTHS ENDED MARCH 31, | |
|--|--------------------------------|----------|
| | 2007 | 2006 |
| Net Cash Provided By Operating Activities | \$ 1,605 | \$ 1,614 |
| Cash Flows From Investing Activities: | | |
| Expenditures for property, plant and equipment | (5,776) | (4,611) |
| Net Cash Used in Investing Activities | (5,776) | (4,611) |
| Cash Flows From Financing Activities: | | |
| Proceeds from issuance of common shares under stock option plans | 218 | 229 |
| Revolving advances, net | 4,400 | |
| Payments on long-term debt | (697) | (689) |
| Net Cash Provided by (Used in) Financing Activities | 3,921 | (460) |
| Net Decrease in Cash and Cash Equivalents | (250) | (3,457) |
| Cash and Cash Equivalents at Beginning of Period | 1,084 | 5,281 |
| Cash and Cash Equivalents at End of Period | \$ 834 | \$ 1,824 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash Paid For: | | |
| Interest | \$ 993 | \$ 851 |
| Income taxes | \$ 682 | \$ 3,163 |
| Non-cash investing and financing activities: | | |
| Capital leases | \$ | \$ 272 |
| Property, plant and equipment acquired but not paid | \$ 1,230 | \$ |

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE AND NINE MONTHS ENDED MARCH 31, 2007 AND 2006

(all dollar amounts in thousands, except per share amounts)

(unaudited)

Note 1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements as of and for the three and nine month periods ended March 31, 2007 and 2006 have been prepared in accordance with Rule 10-01 of Regulation S-X of the Securities and Exchange Commission (SEC) and, as such, do not include all information required by accounting principles generally accepted in the United States of America. These Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements included in the SunLink Health Systems, Inc. (SunLink , we , our , ours , us or the Company) Annual Report on Form 10-K for the fiscal year ended June 30, 2006, with the SEC on September 18, 2006. There have been no material changes to the Significant Accounting Policies described in Note 2 of the audited consolidated financial statements for the fiscal year ended June 30, 2006. In the opinion of management, the Condensed Consolidated Financial Statements, which are unaudited, include all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position and results of operations for the periods indicated. The results of operations for the three and nine month periods ended March 31, 2007 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period.

Note 2. Business Operations and Corporate Strategy

SunLink is a provider of healthcare services through the operation of exurban and rural community hospitals in the United States. In February 2001, SunLink acquired its initial six hospitals and began healthcare operations. On October 3, 2002, SunLink acquired two additional hospitals pursuant to its acquisition of HealthMont, Inc. (HealthMont). On June 1, 2004, SunLink sold its Mountainside Medical Center (Mountainside) facility, a 35-bed hospital located in Jasper, Georgia. Through its subsidiaries, SunLink operates a total of seven community hospitals in four states. Six of the hospitals are owned and one is leased. SunLink also operates certain related businesses, consisting primarily of nursing homes located adjacent to, or in close proximity with, certain of its hospitals, and home health agencies servicing areas around its hospitals. The healthcare operations comprise a single business segment: community hospitals. SunLink currently does not have operations in other business segments. SunLink s hospitals are acute care hospitals and have a total of 402 licensed beds.

SunLink s business strategy is to focus its efforts on internal growth of its seven hospitals supplemented by growth from selected hospital acquisitions. During the nine months ended March 31, 2007, SunLink concentrated its efforts on the operation and improvement of its existing hospitals. During the current fiscal year, SunLink has evaluated certain hospitals which were for sale and monitored selected hospitals which SunLink has determined might become available for sale. SunLink continues to engage in similar evaluation and monitoring activities with respect to hospitals which are or may become available for acquisition.

SunLink announced in December 2005 that its Board of Directors had retained a financial advisor for the purpose of evaluating the Company s strategic alternatives, which alternatives could include a sale of the Company or a merger, acquisition or other transactions. In December 2006, SunLink announced that its Board of Directors had determined to focus the Company s strategic efforts on continued improvement in its existing hospital portfolio and pursuing additional

hospital acquisitions. SunLink also announced that discussions with a company about a potential acquisition of SunLink had been terminated.

Note 3. Discontinued Operations

All of the businesses discussed below are reported as discontinued operations and the condensed consolidated financial statements for all prior periods have been adjusted to reflect this presentation.

Results for all of the businesses included in discontinued operations are presented in the following table:

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|--|---------------------------------|----------|--------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Earnings (Loss) from discontinued operations: | | | | |
| Mountainside Medical Center: | | | | |
| Loss from operations | \$ (121) | \$ (569) | \$ (31) | \$ (551) |
| Income tax benefit | (25) | (226) | (10) | (224) |
| Earnings (Loss) from Mountainside Medical Center after taxes | (96) | (343) | (21) | (327) |
| Life sciences and engineering segment: | | | | |
| Loss from operations | (89) | (30) | (117) | (42) |
| Income tax expense (benefit) | (32) | 4 | (36) | 4 |
| Loss from life sciences and engineering segment after taxes | (57) | (34) | (81) | (46) |
| Earnings (Loss) from discontinued operations | \$ (153) | \$ (377) | \$ (102) | \$ (373) |

Mountainside Medical Center On June 1, 2004, SunLink completed the sale of its Mountainside Medical Center (Mountainside) hospital in Jasper, Georgia, for approximately \$40,000 pursuant to the terms of an asset sale agreement. Under the terms of the agreement, SunLink sold the operations of Mountainside, which included substantially all the property, plant and equipment and the supplies inventory. SunLink retained Mountainside's working capital except for supplies inventory. The retained liabilities of Mountainside are shown in current liabilities of Mountainside Medical Center on the consolidated balance sheet. The pre-tax losses in the three and nine months ended March 31, 2007 resulted primarily from legal expenses related to a claim made by the buyer of Mountainside and a counterclaim made by SunLink. See Legal Proceedings in Note 10 which follows for additional disclosure of the claims. The legal expenses were offset for the nine months ended March 31, 2007 by \$189 of favorable settlements of prior year Medicaid cost reports relating to periods prior to SunLink's sale of Mountainside.

Life Sciences and Engineering Segment SunLink retained a defined benefit retirement plan which covered substantially all of the employees of this segment when it was sold in fiscal 1998. Effective February 28, 1997, the plan was amended to freeze participant benefits and close the plan to new participants. Included in discontinued operations for the three and nine months ended March 31, 2007 and 2006, respectively, were the following:

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|------------------------------------|---------------------------------|-------|--------------------------------|-------|
| | 2007 | 2006 | 2007 | 2006 |
| Service cost | \$ | \$ | \$ | \$ |
| Interest cost | 22 | 9 | 60 | 55 |
| Expected return on assets | (16) | 7 | (40) | (37) |
| Amortization of prior service cost | 6 | 14 | 20 | 24 |
| Net pension expense | \$ 12 | \$ 30 | \$ 40 | \$ 42 |

During the three and nine months ended March 31, 2007, SunLink recognized a curtailment loss of \$77 for partial plan settlement of pension obligations to vested former employees. SunLink contributed \$220 to the plan in the nine months ended March 31, 2007. We do not expect to make any additional contributions to the plan during the remainder of the fiscal year ending June 30, 2007.

Housewares Segment - Beldray Limited (Beldray), SunLink's U.K. housewares manufacturing subsidiary, was sold on October 5, 2001 to two of its managers for nominal consideration. KRUG International U.K. Ltd. (KRUG UK), an inactive U.K. subsidiary of SunLink, entered into a guarantee (the Beldray Guarantee), at a time when it owned Beldray. The Beldray Guarantee covers Beldray's obligations under a lease of a portion of Beldray's former manufacturing facility. In October 2004, KRUG UK received correspondence from the landlord of such facility stating that the rent payment of 94,000 British pounds (\$181) for the fourth quarter of 2004 had not been paid by Beldray and requesting payment of such amount pursuant to the Beldray Guarantee. In January 2005, KRUG UK received further correspondence from the landlord demanding two quarterly rent payments totaling 188,000 British pounds (\$362) under the Beldray Guarantee. In January 2005, the landlord filed a petition in the High Court of Justice Chancery Division to wind up KRUG UK under the provisions of the Insolvency Act of 1986 and KRUG UK was placed into involuntary liquidation by the High Court in February 2005. After that date, the court-appointed liquidator of KRUG UK has made certain inquiries to SunLink regarding the activities of KRUG UK prior to the liquidation to which SunLink has responded.

SunLink's non-current liability reserves for discontinued operations at March 31, 2007, included a reserve for a portion of the Beldray Guarantee. Such reserve was based upon management's estimate, after consultation with its property consultants and legal counsel, of the cost to satisfy the Beldray Guarantee in light of KRUG UK's limited assets and before taking into account any other claims against KRUG UK. The maximum potential obligation of KRUG UK for rent under the Beldray Guarantee is estimated to be approximately \$8,400. As a result of this claim and the U.K. liquidation proceedings against KRUG UK, SunLink expects KRUG UK to be wound-up in liquidation in the UK and has fully reserved for any assets of KRUG UK.

Industrial Segment - In fiscal 1989, SunLink discontinued the operations of its industrial segment and subsequently disposed of substantially all related net assets. However, obligations may remain relating to product liability claims for products sold prior to the disposal.

Discontinued Operations Reserves - Over the past seventeen years SunLink has discontinued operations carried on by its former Mountainside Medical Center and its former industrial, U.K.

leisure marine, life sciences and engineering, and European child safety segments, as well as the U.K. housewares segment. SunLink's reserves relating to discontinued operations of these segments represent management's best estimate of SunLink's possible liability for property, product liability and other claims for which SunLink may incur liability. These estimates are based on management's judgments, using currently available information, as well as, in certain instances, consultation with its insurance carriers, third party advisors and legal counsel. While estimates have been based on the evaluation of available information, it is not possible to predict with certainty the ultimate outcome of many contingencies relating to discontinued operations. SunLink intends to continue to adjust its estimates of the reserves as additional information is developed and evaluated. However, management believes that the final resolution of these contingencies will not have a material adverse impact on the financial position, cash flows or results of operations of SunLink.

Note 4. Stock-Based Compensation

SunLink adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment*, effective July 1, 2005. SFAS No. 123 (R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of such equity instruments. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions such as share options. The effect of adoption of this standard by the Company for the three months ended March 31, 2007 and 2006 was an increase of \$35 and \$199, respectively, in salaries, wages and benefit expense for share options issued to employees and directors of the Company and for the nine months ended March 31, 2007 and 2006 was an increase of \$260 and \$408 respectively, in salaries, wages and benefit expense for share options issued to employees and directors of the Company. The fair value of the share options granted was estimated using the Black-Scholes option pricing model.

Note 5. Recent Accounting Pronouncements

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners* (FSP FIN 45-3). The guidance in this staff position amends FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45) by adding minimum revenue guarantees to the list of example contracts to which FIN 45 applies. Under FSP FIN 45-3, a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. One example cited in FSP FIN 45-3 involves a guarantee provided by a healthcare entity to a non-employed physician in order to recruit such physician to move to the entity's geographical area and establish a private practice. In the example, the healthcare entity also agreed to make payments to the relocated physician if the gross revenue or gross receipts generated by the physician's new practice during a specified time period did not equal or exceed predetermined monetary thresholds.

FSP FIN 45-3 is effective for new minimum revenue guarantees issued or modified on or after January 1, 2006. The Company adopted FSP FIN 45-3 effective January 1, 2006. SunLink's accounting policy for physician guarantees issued prior to January 1, 2006 was to expense guarantees as they were paid. However, under FSP FIN 45-3, the Company expenses the advances paid to physicians over the period of the physician recruiting agreement, which is typically two to three years. The expense recorded for physician guarantees accounted for under

FSP FIN 45-3 during the nine months ended March 31, 2007 was \$587 less than would have been expensed using the Company's previous accounting policy.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140*, which simplifies accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid instrument that contains an embedded derivative that otherwise would require bifurcation and eliminates a restriction on the passive derivative instruments that a qualifying special-purpose entity may hold. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this Statement is not expected to have a material impact on our consolidated results of operations or our consolidated financial position.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140*, which establishes, among other things, the accounting for all separately recognized servicing assets and servicing liabilities by requiring that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits the entity to choose either the amortization method or fair value method for subsequent measurement. SFAS No. 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of SFAS No. 156 is not expected to have a material impact on our consolidated results of operations or our consolidated financial position.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*, which establishes that the financial statement effects of a tax position taken or expected to be taken in a tax return are to be recognized in the financial statements when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect of adopting FIN 48 on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the effect of adopting SFAS No. 157 on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements Nos. 87, 88, 106, and 132(R)*, which requires a business entity to recognize the overfunded or underfunded status of a single-employer defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in comprehensive income in the year in which the changes occur. SFAS No. 158 also requires a business entity to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The Company is required to adopt this Statement as of the end of the fiscal year ended June 30, 2007. There is projected to be no effect on the consolidated statement of earnings from the adoption of this statement. We expect that the pension asset recognized in the consolidated balance sheet will be reduced by an offsetting amount in shareholders' equity in the

accumulated other comprehensive loss. If this Statement had been adopted by the Company at June 30, 2006, pension asset and shareholders equity would have been reduced by \$456, the amount of the unrecognized actuarial loss at June 30, 2006 determined under FASB Statement No. 87.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. It also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the effect of adopting SFAS No. 159 on the Company's consolidated financial statements.

In September 2006, the U.S. Securities and Exchange Commission (SEC) staff added Section N to Staff Accounting Bulletin (SAB) Topic 1 through the issuance of SAB 108 - *Financial Statements - Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 addresses how a company should evaluate whether an error in its financial statements is material. The guidance in SAB 108 will be effective for annual financial statements with fiscal years ending after November 15, 2006. The Company is currently evaluating the impact of adopting SAB 108 on the Company's consolidated financial statements.

Note 6. Receivables- net

Summary information for receivables is as follows:

| | March 31, | June 30, |
|---|------------------|------------------|
| | 2007 | 2006 |
| Patient accounts receivable (net of contractual allowances) | \$ 27,835 | \$ 25,425 |
| Less allowance for doubtful accounts | (11,591) | (8,931) |
| Receivables - net | \$ 16,244 | \$ 16,494 |

Net revenues included reductions of \$94 and an increase of \$10 for the three months ended March 31, 2007 and 2006, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports. Net revenues included a reduction of \$301 and an increase of \$268 for the nine months ended March 31, 2007 and 2006, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

Note 7. Long-Term Debt

Long-term debt consisted of the following:

| | March 31, | June 30, |
|---------------------------|-----------------|-----------------|
| | 2007 | 2006 |
| SunLink Term Loan A | \$ 8,389 | \$ 8,889 |
| Capital lease obligations | 306 | 504 |
| | 8,695 | 9,393 |
| Less current maturities | (868) | (928) |
| | \$ 7,827 | \$ 8,465 |

SunLink Credit Facility - On October 15, 2004, SunLink entered into a \$30,000 five-year senior secured credit facility comprised of a revolving line of credit of up to \$15,000 with an interest rate at LIBOR plus 2.91%, a \$10,000 term loan (SunLink Term Loan A) with an interest rate at LIBOR plus 3.91% and a \$5,000 term loan facility (SunLink Term Loan B) with an interest rate at LIBOR plus 3.91%. The revolving line of credit and the SunLink Term Loan A were immediately available to the Company as of October 15, 2004. The SunLink Term Loan A was fully drawn on October 15, 2004. The SunLink Term Loan B closed on November 15, 2004. The \$10,000 SunLink Term Loan A and draws under the \$5,000 SunLink Term Loan B are repayable based on a 15-year amortization from the date of draw with final balloon payments due at the end of the five-year maturity of the credit facility. The total availability under all components of the credit facility is keyed to the level of SunLink's earnings, which would have provided for current total borrowing capacity at March 31, 2007 of approximately \$27,633. Debt outstanding under the facility as of March 31, 2007 was the SunLink Term Loan A of \$8,389 and \$4,400 of the revolving line of credit. SunLink may use the remaining funds available from the revolving line of credit for hospital capital projects, equipment purchases and for working capital needs. Borrowing under the \$5,000 SunLink Term Loan B may be used, subject to satisfaction of certain covenants, to satisfy certain specified claims and obligations, to fund acquisitions or to reacquire the Company's securities. The credit facility is secured by a first priority security interest in all assets and properties, real and personal, of the Company and its consolidated domestic subsidiaries, including a pledge of all of the equity interests in such subsidiaries.

Note 8. Income Taxes

Income tax expense of \$599 (\$526 federal tax and \$73 state tax expense) and income tax expense of \$659 (\$485 federal tax and \$174 state tax expense) was recorded for the three months ended March 31, 2007 and 2006, respectively. The \$526 federal tax expense for the three months ended March 31, 2007 included \$440 deferred income tax benefit. The \$485 federal tax expense for the three months ended March 31, 2006 included \$49 deferred income tax expense. Income tax expense of \$645 (\$556 federal tax expense and \$89 state tax expense) and \$2,035 (\$1,714 federal tax expense and \$321 state tax expense) was recorded for the nine months ended March 31, 2007 and 2006, respectively. The \$556 federal tax expense for the nine months ended March 31, 2007 included \$410 deferred income tax benefit. The \$1,714 federal tax expense for the nine months ended March 31, 2006 included \$321 deferred income tax expense. We had an estimated net operating loss carry-forward for federal income tax purposes of approximately \$7,400 at March 31, 2007. Use of this net operating loss carry-forward is subject to the limitations of the provisions of Internal Revenue Code Section 382. As a result, not all of the net operating loss carry-forward is available to offset federal taxable income in the current year. At March 31, 2007, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was \$1,828. Based upon management's assessment that it was more likely than not that a portion of its domestic deferred tax asset (primarily its domestic net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the domestic tax asset which may not be utilized. The Company has provided a valuation allowance for the entire amount of the foreign tax asset as it is more likely than not that none of the foreign deferred tax assets will be realized through future taxable income or implementation of tax planning strategies.

Note 9. Comprehensive Earnings

Comprehensive earnings for SunLink include foreign currency translation adjustments and change in minimum pension liability. The foreign currency translation adjustment results primarily from the effect of changes in the exchange rates of the UK pound on the Company's reserve for the Beldray Guarantee (See Note 3. *Discontinued Operations*). Total comprehensive earnings for the following periods were as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------|-------------------|-----------|
| | March 31, | March 31, | March 31, | March 31, |
| | 2007 | 2006 | 2007 | 2006 |
| Net earnings: | \$ 459 | \$ 632 | \$ 515 | \$ 2,637 |
| Other comprehensive income net of tax: | | | | |
| Change in equity due to : | | | | |
| Change in minimum pension liability | | (7) | | (7) |
| Foreign currency translation adjustments | (6) | 7 | (66) | 42 |
| Comprehensive earnings (loss) | \$ 453 | \$ 632 | \$ 449 | \$ 2,672 |

Note 10. Commitments and ContingenciesLegal Proceedings

On July 13, 2006, Piedmont Healthcare, Inc. (*PHI*) and Piedmont Mountainside Hospital, Inc. (*PMH*) (collectively the *Plaintiffs* or *Piedmont*) filed a Complaint in the Superior Court of Cobb County, Georgia, alleging breach of the Asset Purchase Agreement (the *Agreement*) dated as of April 9, 2004 by and among *PMH*, Piedmont Medical Center, Inc. (n/k/a *PMI*), Southern Health Corporation of Jasper, Inc. (*SHCJ*), SunLink Healthcare LLC (formerly SunLink Healthcare Corp.) and SunLink (collectively *Defendants* or *SunLink*) pursuant to which the Mountainside Medical Center was sold to *PMH* in June 2004. Specifically, Piedmont seeks to have SunLink reimburse Piedmont for certain costs associated with an alleged indigent and charity care shortfall of Piedmont Mountainside Hospital (formerly Mountainside Medical Center) for the fiscal year ended June 30, 2004 demanded by the Georgia Department of Community Health (*DCH*). In addition, Piedmont seeks reimbursement for funds allegedly recouped from *PMH* by *DCH* in respect of Medicaid Cost Report settlements and adjustments for the reporting periods ended June 30, 2002, June 30, 2003 and May 31, 2004. Piedmont also seeks a declaratory judgment to the effect that *PMH* may retain certain payments it has received or likely will receive from the *DCH*'s Indigent Care Trust Fund for Disproportionate Share Hospitals. Piedmont also seeks recovery of costs and attorney's fees pursuant to the *Agreement* and under Georgia Law.

On August 11, 2006, SunLink filed an Answer to the complaint asserting factual and legal defenses, along with a Counterclaim. In the Counterclaim, *SHCJ* alleges that *PMH* breached the *Agreement* by failing to reimburse *SHCJ* for certain Medicaid Cost Report adjustments for the reporting periods ended June 30, 1999, and June 30, 2000, as well as funds paid or expected to be paid to *PMH* from the *DCH*'s Indigent Care Trust Fund for Disproportionate Share Hospitals, which payments *Defendants* contend qualify as *excluded assets* not sold to *PMH* under the *Agreement*. *SHCJ* also alleged that *PMH* breached the *Agreement* by failing to cooperate with

SHCJ in an appeal of certain Medicaid Cost Reports settlements for the reporting period ended June 30, 2002, June 30, 2003 and May 31, 2004. SHCJ further alleged that Piedmont breached its obligations to guarantee PMH's payment and performance of its obligations under the Agreement. SunLink seeks a declaratory judgment regarding the parties' rights in respect of the Medicaid Cost Report settlements and adjustments, as well as the payment made and expected to be made under the Indigent Care Trust Fund. Finally, SunLink seeks to recover their costs and attorney's fees pursuant to the Agreement and under Georgia law.

SunLink denies that it has any liability to the Plaintiffs and intends to vigorously defend the claims asserted against SunLink in connection with the Complaint. While the ultimate outcome and materiality of the Complaint cannot be determined, in management's opinion the Complaint will not have a material adverse effect on SunLink's financial condition or results of operations.

SunLink is a party to claims and litigation incidental to its business, for which it is not currently possible to determine the ultimate liability, if any. Based on an evaluation of information currently available and consultation with legal counsel, management believes that resolution of such claims and litigation is not likely to have a material effect on the financial position, cash flows, or results of operations of the Company. The Company expenses legal costs as they are incurred.

Discontinued Operations

As discussed in Note 3 *Discontinued Operations*, SunLink sold its former U.K. housewares manufacturing subsidiary, Beldray Limited (Beldray), to two of its managers in October 2001. Beldray has since entered into administrative receivership and is under the administration of its primary lender. SunLink believes Beldray ceased to operate in October 2004.

As previously disclosed, KRUG International U.K. Ltd. (KRUG UK), an inactive U.K. subsidiary of SunLink, entered into a guarantee (the Beldray Guarantee), at a time when it owned Beldray. The Beldray Guarantee covers Beldray's obligations under a lease of a portion of Beldray's former manufacturing facility. In October 2004, KRUG UK received correspondence from the landlord of such facility stating that the rent payment of 94,000 British pounds (\$181) for the fourth quarter of 2004 had not been paid by Beldray and requesting payment of such amount pursuant to the Beldray Guarantee. In January 2005, KRUG UK received further correspondence from the landlord demanding two quarterly rent payments totaling 188,000 British pounds (\$362) under the Beldray Guarantee. In January 2005, the landlord filed a petition in the High Court of Justice Chancery Division to wind up KRUG UK under the provisions of the Insolvency Act of 1986 and KRUG UK was placed into involuntary liquidation by the High Court in February 2005. After that date, the court-appointed liquidator of KRUG UK has made certain inquiries to SunLink regarding the activities of KRUG UK prior to the liquidation to which SunLink has responded.

SunLink's non-current liability reserves for discontinued operations at March 31, 2007, included a reserve for a portion of the Beldray Guarantee. Such reserve was based upon management's estimate, after consultation with its property consultants and legal counsel, of the cost to satisfy the Beldray Guarantee in light of KRUG UK's limited assets and before taking into account any other claims against KRUG UK. The maximum potential obligation of KRUG UK for rent under the Beldray Guarantee is estimated to be approximately \$8,400. As a result of this claim and the U.K. liquidation proceedings against KRUG UK, SunLink expects KRUG UK to be wound-up in liquidation in the UK and has fully reserved for any assets of KRUG UK.

Capital Improvements

As of March 31, 2007, SunLink had approximately \$1,230 in accounts payable for capital expenditures accepted prior to the quarter end. The Company has also begun a major renovation project at our Dahlonega, Georgia, facility and a free standing diagnostic center in Dawsonville, Georgia, which has a combined estimated cost of approximately \$6,900, of which approximately \$1,700 of cost has been paid or accrued to date and of which approximately \$1,900 additional costs will be paid or accrued by the end of the current fiscal year. There are no other material future commitments for capital expenditures except for the Dahlonega, Georgia major renovation and the Dawsonville, Georgia, free standing diagnostic center projects. In April, 2007, the Company filed Certificate of Need application with the state of Georgia to build a replacement hospital in Ellijay, Georgia. No action has been taken on the application and to date SunLink has made no commitments related to the replacement hospital. Subject to the availability of internally generated funds and other financing, SunLink currently expects to spend approximately \$2,500 in capital expenditures (in addition to the \$1,230 in accounts payable at quarter end) during the remaining three months of the fiscal year ending June 30, 2007, primarily for the hospital expansion project and new and replacement equipment.

Other

SunLink's strategy is to focus its efforts on internal growth of its seven hospitals supplemented by growth from selected acquisitions. Subject to the availability of debt and/or equity capital, SunLink's future growth may include replacement or expansion of its existing hospitals involving substantial capital expenditures, as well as the expenditure of significant amounts of capital for selected hospital acquisitions.

SunLink became self-insured for employee health risks on October 1, 2006. For the period October 1, 2005 to September 30, 2006, SunLink had a fully-insured employee health insurance plan.

SunLink has established an off-shore captive insurance subsidiary which it is planned will be used to help finance its professional liability insurance and workers' compensation insurance claims.

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases, physician guarantees and interest on outstanding debt from continuing operations at March 31, 2007 were as follows:

| Payments due in: | Long-Term Debt | Operating Leases | Physician Guarantees | Interest on Outstanding Debt |
|-------------------------|---------------------------|-----------------------------|---------------------------------|---|
| 1 year | \$ 868 | \$ 2,043 | \$ 972 | \$ 754 |
| 2 years | 750 | 1,691 | 182 | 685 |
| 3 years | 7,077 | 1,322 | | 319 |
| 4 years | | 866 | | |
| 5 years | | 489 | | |
| More than 5 years | | 1,748 | | |
| | \$ 8,695 | \$ 8,159 | \$ 1,154 | \$ 1,758 |

At March 31, 2007, SunLink had contracts with 9 physicians which contain guaranteed minimum gross receipts. Physician guarantee contracts entered into after January 1, 2006 are accounted for under the provisions of FSP FIN 45-3. See Note 5 Recent Accounting Pronouncements for discussion of FSP FIN 45-3. For guarantee contracts entered into prior to the adoption of FSP FIN 45-3, SunLink expenses physician guarantees as they are determined to be due to the

physician on an accrual basis. Each month the physician's gross patient receipts are accumulated and the difference between the monthly guarantee and the physician's actual gross receipts for the month is calculated. If the guarantee is greater than the receipts, the difference is accrued as a liability and an expense. The net guarantee amount is paid to the physician in the succeeding month. If the physician's monthly receipts exceed the guarantee amount in subsequent months, then the overage is repaid to SunLink to the extent of any prior monthly guarantee payments and the liability and expense is reduced by the amount of the repayments. The physician with whom a guarantee agreement is made agrees to maintain their practice within the hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician's liability for any guarantee repayment due to non-compliance with guarantee provisions generally is collateralized by the physician's patient accounts receivable and/or a promissory note from the physician. Included in the Company's consolidated balance sheet at March 31, 2007 is a liability of \$676 for 8 physician guarantees accounted for under the provisions of FSP FIN 45-3. SunLink expensed \$189 and \$420 for the three months ended March 31, 2007 and 2006, respectively, and expensed \$836 and \$1,305 for the nine months ended March 31, 2007 and 2006, respectively. The table above shows noncancelable commitments under physician guarantee contracts as of March 31, 2007.

In March 2007, one of the Company's hospitals received a past due tax statement from the Internal Revenue Service (IRS) demanding approximately \$832 for a civil penalty related to payroll taxes allegedly unpaid for the year ending December 31, 1999. The Company acquired this hospital in 2001. The hospital had earlier received a notice from the IRS in May 2006 about a payroll tax deficiency for calendar 1999, but after reviewing the payroll tax records for calendar 1999 provided by the IRS, the Company believes that all the payroll taxes, assessed penalties and related interest for calendar 1999 have been paid by the hospital and that no amounts should be due. The Company has written the IRS to obtain an explanation of this civil penalty and to obtain a resolution of this matter. No response from the IRS has been received. The Company does not have any amount accrued for this matter at March 31, 2007 as it does not believe any taxes are due for the year ended December 31, 1999, nor is the Company aware of any matter that would cause a civil penalty to be levied.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(dollars in thousands, except per share and admissions data)

Forward-Looking Statements

This Quarterly Report and the documents that are incorporated by reference in this Quarterly Report contain certain forward-looking statements within the meaning of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that do not relate solely to historical or current facts and may be identified by the use of words such as may, believe, will, expect, project, estimate, anticipate, plan or continue. These forward-looking statements are based on our current plans and expectations and are subject to a number of risks, uncertainties and other factors which could significantly affect current plans and expectations and our future financial condition and results. These factors, which could cause actual results, performance and achievements to differ materially from those anticipated, include, but are not limited to:

General Business Conditions

general economic and business conditions in the U.S., both nationwide and in the states in which we operate hospitals;

the competitive nature of the U.S. community hospital business;

demographic changes in areas where we operate hospitals;

the availability of cash or borrowings to fund working capital, renovations, replacement, expansion and capital improvements at existing hospital facilities and for acquisitions and replacement hospital facilities;

changes in accounting principles generally accepted in the U.S.; and,

fluctuations in the market value of equity securities including SunLink common shares;

Operational Factors

the availability of, and our ability to attract and retain, sufficient qualified staff physicians, management, nurses and staff personnel for our hospital operations;

timeliness and amount of reimbursement payments received under government programs;

restrictions imposed by debt agreements;

the cost and availability of insurance coverage including professional liability (e.g., medical malpractice) and general liability insurance;

the efforts of insurers, healthcare providers, and others to contain healthcare costs;

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the impact on hospital services of the treatment of patients in lower acuity healthcare settings, whether with drug therapy or via alternative healthcare services, such as surgery centers or urgent care centers;

changes in medical and other technology;

risks of mis-estimation of self insurance claims and reserves;

increases in prices of materials and services utilized in our hospital operations;

increases in wages and benefits as a result of inflation or competition for management, physician, nursing and staff positions;

increases in the amount and risk of collectibility of accounts receivable, including deductibles and co-pay amounts; and,

delays or unanticipated costs with respect to the full implementation of a new management information system for our hospitals, including both software and hardware;

Liabilities, Claims, Obligations and Other Matters

claims under leases, guarantees and other obligations relating to discontinued operations, including sold facilities, retained or acquired subsidiaries and former subsidiaries;

potential adverse consequences of known and unknown government investigations;

claims for product and environmental liabilities from continuing and discontinued operations; and,

professional, general and other claims which may be asserted against us:

Regulation and Governmental Activity

existing and proposed governmental budgetary constraints;

the regulatory environment for our businesses, including state certificate of need laws and regulations, rules and judicial cases relating thereto;

anticipated adverse changes in the levels and terms of government (including Medicare, Medicaid and other programs) and private reimbursement for SunLink's healthcare services including the payment arrangements and terms of managed care agreements;

changes in or failure to comply with Federal, state or local laws and regulations affecting the healthcare industry; and,

the possible enactment of Federal healthcare reform laws or reform laws in states where we operate hospital facilities (including Medicaid waivers and other reforms);

Acquisition Related Matters

the availability and terms of capital to fund additional acquisitions or replacement facilities;

our ability to integrate acquired hospitals and implement our business strategy; and,

competition in the market for acquisitions of hospitals and healthcare facilities.

As a consequence, current plans, anticipated actions and future financial condition and results may differ from those expressed in any forward-looking statements made by or on behalf of SunLink. You are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in this Form 10-Q. We have not undertaken any obligation to publicly update or revise any forward-looking statements.

Corporate Business Strategy

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Since 2001, our business strategy has focused on the acquisition and operation of community hospitals in the United States. On February 1, 2001, SunLink purchased five community hospitals, leasehold rights for a sixth existing hospital and the related businesses of all six hospitals for approximately \$26,500. In October 2003, we acquired two additional hospitals through our acquisition of HealthMont, Inc. In June 2004, we sold our Mountainside Medical Center, a 35-bed hospital located in Jasper, GA for approximately \$40,000. Through our subsidiaries, we currently operate a total of seven community hospitals in four states. Currently six of the hospitals are owned and one is leased.

Our primary operational strategy is to improve the profitability of our hospitals by reducing out-migration of patients, recruiting physicians, expanding services and implementing and maintaining effective cost controls. Our efforts are focused on internal growth. However, we actively seek to supplement internal growth through acquisitions. Our acquisition strategy is to selectively acquire community hospitals with net revenues of approximately \$10,000 or more which are (1) the sole or primary hospital in market areas with a population of greater than 15,000 or (2) a principal healthcare provider with substantial market share in communities with a population of 50,000 to 150,000. We believe all of our seven existing hospitals meet at least one

of these two market area criteria. The Company considers prices paid by others in recent years for certain hospital acquisitions to be higher than we would be willing to pay but believes there may be opportunities for acquisitions of individual hospitals (particularly not-for-profit hospitals) in the future due to, among other things, negative trends in certain government reimbursement programs and other factors. From time to time we may consider hospitals for disposition if we determine their operating results or potential growth no longer meet our strategic objectives.

SunLink announced in December 2005 that its Board of Directors had retained a financial advisor for the purpose of evaluating the Company's strategic alternatives, which alternatives could include a sale of the Company or a merger, acquisition or other transactions. In December 2006, SunLink announced that its Board of Directors had determined to focus the Company's strategic efforts on continued improvement in its existing hospital portfolio and pursuing additional hospital acquisitions. SunLink also announced that discussions with a company about a potential acquisition of SunLink had been terminated.

Critical Accounting Estimates

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect reported amounts and related disclosures. We consider an accounting estimate to be critical if:

it requires assumptions to be made that were uncertain at the time the estimate was made; and

changes in the estimate or different estimates that could have been made could have a material impact on our consolidated results of operations or financial condition.

Our critical accounting estimates are more fully described in our 2006 Annual Report on Form 10-K and continue to include the following areas:

Receivables net and provision for doubtful accounts;

Revenue recognition / Net Patient Service Revenues;

Goodwill and accounting for business combinations;

Professional and general liability claims; and

Accounting for income taxes.

Financial Summary

The results of continuing operations shown in the financial summary below are for our sole business segment, U.S. community hospitals, which is composed of five SunLink facilities acquired February 1, 2001 (SHL Facilities) and two HealthMont facilities acquired October 3, 2003 (HealthMont Facilities).

| | THREE MONTHS ENDED | | | NINE MONTHS ENDED | | |
|---|--------------------|-----------|----------|-------------------|------------|----------|
| | March 31, | | | March 31, | | |
| | 2007 | 2006 | % Change | 2007 | 2006 | % Change |
| Net revenues | \$ 37,490 | \$ 34,630 | 8.3% | \$ 106,049 | \$ 100,771 | 5.2% |
| Cost of patient service revenues | (35,917) | (32,685) | 9.9% | (103,790) | (94,927) | 9.3% |
| Operating profit (loss) | 1,573 | 1,945 | (19.2%) | 2,259 | 5,844 | (61.3%) |
| Interest expense | (368) | (285) | 29.1% | (1,018) | (846) | 20.3% |
| Interest income | 6 | 8 | (25.0%) | 21 | 47 | (55.3%) |
| Earnings (Loss) from Continuing Operations before Income Taxes | \$ 1,211 | \$ 1,668 | (27.4%) | \$ 1,262 | \$ 5,045 | (75.0%) |
| Admissions | 2,709 | 2,680 | 1.1% | 7,518 | 7,672 | (2.0%) |
| Equivalent Admissions | 6,862 | 6,367 | 7.8% | 20,017 | 19,035 | 5.2% |
| Surgeries | 1,239 | 1,197 | 3.5% | 3,627 | 3,729 | (2.7%) |
| Revenue per Equivalent Admission | \$ 5,463 | \$ 5,439 | 0.4% | \$ 5,298 | \$ 5,294 | 0.1% |

Equivalent admissions Equivalent admissions is used by management (and certain investors) as a general measure of combined inpatient and outpatient volume. Equivalent admissions are computed by multiplying admissions (inpatient volume) by the sum of gross inpatient revenues and gross outpatient revenues and dividing the result by gross inpatient revenues. The equivalent admissions computation is intended to relate outpatient revenues to the volume measure (admissions) used to measure inpatient volume to result in a general approximation of combined inpatient and outpatient volume (equivalent admissions).

Results of Operations

Net revenues for the quarter ended March 31, 2007 were \$37,490 with a total of 6,862 equivalent admissions and revenue per equivalent admission of \$5,463 compared to net revenues of \$34,630, a total of 6,367 equivalent admissions and revenue per equivalent admission of \$5,439 for the quarter ended March 31, 2006. The 8.3% increase in net revenues for the quarter ended March 31, 2007 was due to a 7.8% increase in equivalent admissions, a 1.1% increase in admissions and a 3.5% increase in surgeries. Self-pay revenues increased 40.9% in the current year's quarter. Net revenue for the three months ended March 31, 2007 and 2006, included net revenues of \$406 and \$762, respectively, from state indigent care programs. Net revenues for the three months ended March 31, 2007 included a reduction of \$94 for the settlements and filings of prior year Medicare and Medicaid cost reports compared to a net revenue increase of \$10 for the three months ended March 31, 2006. Net outpatient service revenues increased by \$4,025, a 29% increase from last year to \$17,914 for the three months ended March 31, 2007 and increased to 47.8% of net revenues from 40.1% last year. The decreased net revenues from state indigent care

programs and cost settlements in the current year contributed to the increase in the percentage of net outpatient services as a percentage of net revenue.

Net revenues for the nine months ended March 31, 2007 were \$106,049 with a total of 20,017 equivalent admissions and revenue per equivalent admission of \$5,298 compared to net revenues of \$100,771, a total of 19,035 equivalent admissions and revenue per equivalent admission of \$5,294 for the nine months ended March 31, 2006. The 5.2% increase in net revenues for the nine months ended March 31, 2007 was due to a 5.2% increase in equivalent admissions. Net outpatient service revenues increased by \$6,359, a 14.4% increase from last year to \$50,511 for the nine months ended March 31, 2007 and increased to 47.6% of net revenues from 43.8% last year. Net revenues for the nine months ended March 31, 2007 and 2006, included net revenues of \$1,219 and \$1,209, respectively, from state indigent care programs. Net revenues included a reduction of \$301 and an increase of \$268 for the nine months ended March 31, 2007 and 2006, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

Recruitment of new doctors and spending for capital improvements have contributed to the increase in net revenues. We added 13 net new doctors during the year ended June 30, 2006 and eight net new doctors during the nine months ended March 31, 2007. During the nine months ended March 31, 2007, SunLink expensed \$836 on physician guarantees and recruiting expenses compared to \$1,305 for the same period last year. We also have expended approximately \$13,788 for capital expenditures to upgrade services and facilities since July 1, 2005. We believe the recent and ongoing upgrades to our services and facilities and the new doctors contributed to the increase in net revenues for the three and nine months ended March 31, 2007 compared to the same periods of the prior year. We continue to seek increased patient volume by attracting additional physicians to our hospitals, further upgrading the services offered by the hospitals and improving the hospitals physical facilities.

The following table sets forth the percentage of net patient revenues from major payor sources for the Company's hospitals during the periods indicated:

| Source | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|------------------------------|---------------------------------|--------|--------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Medicare | 46.7% | 47.4% | 46.3% | 45.9% |
| Medicaid | 13.7% | 15.7% | 15.0% | 16.4% |
| Self pay | 9.9% | 7.6% | 9.4% | 7.9% |
| Commercial Insurance & Other | 29.7% | 29.3% | 29.3% | 29.8% |
| | 100.0% | 100.0% | 100.0% | 100.0% |

During the three months ended March 31, 2007, we experienced a decrease in Medicare and Medicaid as a percentage of net revenues with an increase in self pay net revenues as a percentage of net revenues compared to last year. In absolute dollars, Medicare net revenues increased in the three months ended March 31, 2007 compared to the prior year, but the increases were at lower rates than the overall 8.3% increase in net revenues.

The Company received supplemental Medicaid payments for state indigent care programs from three states in the fiscal year ended June 30, 2006. In the current fiscal year, which ends June 30, 2007, we have received these supplemental Medicaid payments for state indigent programs from only one state. We expect to receive the payments from a second state as the indigent care program has been established for the year ending June 30, 2007 however no funding

for the program has yet been authorized by that state. We received approximately \$1,826 for indigent programs from this state in the fiscal year ended June 30, 2006 for two facilities. We have qualified three facilities under the proposed indigent care program in this state for the year ending June 30, 2007. There can be no assurance that any further indigent care funds will be received in the fiscal year ended June 30, 2007 or in future years.

Cost of patient service revenues, including depreciation, was \$35,917 and \$32,685 for the three months ended March 31, 2007 and 2006, respectively, and \$103,790 and \$94,927 for the nine months ended March 31, 2007 and 2006, respectively.

| | Cost of Patient Service Revenues As % of Net Revenues | | | |
|------------------------------|--|-------------|------------------------------------|-------------|
| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
| | 2007 | 2006 | 2007 | 2006 |
| Salaries, wages and benefits | 47.5% | 49.5% | 49.9% | 49.1% |
| Provision for bad debts | 14.7% | 9.5% | 13.9% | 10.6% |
| Supplies | 11.1% | 10.3% | 11.3% | 10.7% |
| Purchased services | 6.0% | 6.2% | 6.3% | 6.3% |
| Other operating expenses | 11.8% | 14.5% | 11.6% | 13.3% |
| Rent and lease expense | 1.8% | 1.7% | 2.0% | 1.8% |

Salaries, wages and benefits expense decreased as a percentage of net revenues for the three months ended March 31, 2007 due to decreased contract labor expense and salaries and wages expense. Salaries, wages and benefits expense increased only 3.9% in the current year's quarter compared to the same quarter a year ago while net revenues increased 8.3% for the same periods.

Provision for bad debts increased as a percent of net revenue in the current year due to higher self-pay net revenues for the three and nine months ended March 31, 2007 as compared to the comparable periods of the last year and increases in charges for services rendered that could not be collected. Self-pay net revenues increased approximately 40.9% in the quarter ended March 31, 2007 and 24.8% for the nine months ended March 31, 2007 compared to the prior year's comparable periods. This increase resulted in a higher provision for bad debts due to the low collection percentages for self-pay revenues. The increase in self-pay revenues is partially due to a lower percentage of net revenues for Medicaid services. Medicaid net revenues decreased from 15.7% in the quarter ended March 31, 2006 to 13.7% this year.

Other operating expenses for the nine months ended March 31, 2007 decreased compared to last year due to lower insurance expense. The decrease in insurance expense resulted from lower insurance costs and lower actuarially-determined liability for professional risks. Insurance expense for the nine months ended March 31, 2007 benefited from a \$938 reduction due to reducing the actuarially-determined liability for professional liability risks.

Depreciation and amortization expense increased \$223 and \$801 for the three and nine months ended March 31, 2007 compared to the comparable prior year periods. The increase in the current year was due primarily to the approximately \$13,788 of capital expenditures in the past 21 months.

Operating profit for the three months ended March 31, 2007 was \$1,573 compared to operating profit of \$1,945 for the three months ended March 31, 2006. The lower operating profit in the current year was primarily attributable to the higher provision for bad debts this year, lower

net revenues from state indigent care programs and \$104 reduced net revenues from the settlements and filings of prior year Medicare and Medicaid cost reports. Operating profit for the nine months ended March 31, 2007 was \$2,259 compared to operating profit of \$5,844 last year. The decrease in operating profit in the current year is attributable to the higher provision for bad debts, and salaries, wages and benefits and depreciation and amortization expense this year.

Interest expense was \$368 and \$285 for the three months ended March 31, 2007 and 2006, respectively, and was \$1,018 and \$846 for the nine months ended March 31, 2007 and 2006, respectively. The higher interest expense in the current year was due to higher interest rates related to the SunLink Term Loan and use of the revolving line of credit in the current year. The revolving line of credit has been used this year to fund SunLink's capital expenditures.

Income tax expense of \$599 (\$526 federal tax and \$73 state tax expense) and \$659 (\$485 federal tax and \$174 state tax expense) was recorded for the three months ended March 31, 2007 and 2006, respectively. The \$526 federal tax expense for the three months ended March 31, 2007 included \$440 deferred income tax benefit. The \$485 federal tax expense for the three months ended March 31, 2006 included \$49 deferred income tax expense. Income tax expense of \$645 (\$556 federal tax expense and \$89 state tax expense) and \$2,035 (\$1,714 federal tax expense and \$321 state tax expense) was recorded for the nine months ended March 31, 2007 and 2006, respectively. The \$556 federal tax expense for the nine months ended March 31, 2007 included \$410 deferred income tax benefit. The \$1,714 federal tax expense for the nine months ended March 31, 2006 included \$321 deferred income tax expense. We had an estimated net operating loss carry-forward for federal income tax purposes of approximately \$7,400 at March 31, 2007. Use of this net operating loss carry-forward is subject to the limitations of the provisions of Internal Revenue Code Section 382. As a result, not all of the net operating loss carry-forward is available to offset federal taxable income in the current year. At March 31, 2007, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was \$1,828. Based upon management's assessment that it was more likely than not that a portion of its domestic deferred tax asset (primarily its domestic net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the domestic tax asset which may not be utilized. The Company has provided a valuation allowance for the entire amount of the foreign tax asset as it is more likely than not that none of the foreign deferred tax assets will be realized through future taxable income or implementation of tax planning strategies.

Earnings from continuing operations were \$612 (\$0.08 per fully diluted share) for the quarter ended March 31, 2007 compared to earnings from continuing operations of \$1,009 (\$0.13 per fully diluted share) for the comparable quarter last year. The lower earnings in the current year resulted from the lower operating profit, higher interest expense and higher income taxes. Earnings from continuing operations were \$617 (\$0.08 per fully diluted share) for the nine months ended March 31, 2007 compared to earnings from continuing operations of \$3,010 (\$0.38 per fully diluted share) for the comparable period last year.

In the three months ended March 31, 2007, the Company recorded a curtailment loss of \$77 for partial plan settlement of pension obligations to vested former employees of discontinued operations and also incurred legal expenses for a lawsuit relating to its former Mountainside Medical Center. These expenses were the main cause of the after-tax loss from discontinued of \$153 (\$0.02 per fully diluted share) for the period. In the nine months ended March 31, 2007, the after-tax loss from discontinued operations was \$102 (\$0.01 per fully diluted share).

Net earnings were \$459 (\$0.06 per share) in the quarter ended March 31, 2007 compared to net earnings of \$632 (\$0.08 per fully diluted share) in the quarter ended March 31, 2006. Net earnings for the nine months ended March 31, 2007 were \$515 (\$0.07 per fully diluted share) compared to \$2,637 (\$0.34 per fully diluted share) for the nine months ended March 31, 2006.

Adjusted earnings before income taxes, interest, depreciation and amortization

Earnings before interest, income taxes, depreciation and amortization (EBITDA) represent the sum of income before interest, income taxes, depreciation and amortization. We understand that certain industry analysts and investors generally consider EBITDA to be one measure of the liquidity of a company, and it is presented to assist analysts and investors in analyzing the ability of the company to generate cash, service debt and meet capital requirements. We believe increased EBITDA, and more particularly in the case of the Company, Adjusted EBITDA, is an indicator of improved ability to service existing debt and to satisfy capital requirements. Neither EBITDA nor Adjusted EBITDA is a measure of financial performance under accounting principles generally accepted in the United States of America and should not be considered an alternative to net income as a measure of operating performance or cash liquidity. Because EBITDA is not a measure determined in accordance with accounting principles generally accepted in the United States of America and is thus susceptible to varying calculations, EBITDA, as presented, may not be comparable to other similarly titled measures of other corporations. Similarly, other presentations of adjusted EBITDA may not adjust for similar items or compute corporate overhead in the same manner. Net cash provided by (used in) operations for the three and nine months ended March 31, 2007 and 2006, respectively, is shown below. SHL and HealthMont Facilities Adjusted EBITDA is the EBITDA for those facilities without any allocation of corporate overhead.

| | Three Months ended | | Nine Months ended | |
|---|--------------------|-------------------|-------------------|-------------------|
| | March 31, 2007 | March 31, 2006 | March 31, 2007 | March 31, 2006 |
| SHL Facilities Adjusted EBITDA | \$ 2,838 | \$ 3,639 | \$ 6,963 | \$ 10,338 |
| HealthMont Facilities Adjusted EBITDA | 745 | 480 | 1,636 | 1,772 |
| Facilities Adjusted EBITDA | 3,583 | 4,119 | 8,599 | 12,110 |
| Corporate overhead costs | (921) | (1,308) | (3,121) | (3,848) |
| Taxes and interest expense | (961) | (936) | (1,642) | (2,834) |
| Other non-cash expenses and net changes in operating assets and liabilities | (1,006) | (2,036) | (2,231) | (3,814) |
| Net cash provided by (used in) operations | \$ 695 | \$ (161) | \$ 1,605 | \$ 1,614 |

Liquidity and Capital Resources

We generated \$1,605 of cash from operating activities during the nine months ended March 31, 2007 compared to \$1,614 of cash generated during the comparable period last year. The cash generated from operations in the nine months ended March 31, 2007 resulted from increased accounts payable and other liabilities, decreased patient receivables and \$3,219 of depreciation and amortization offset by \$931 used for the reduction of the liabilities of Mountainside Medical Center, income tax payments of \$682 and cash used for increased medical supplies.

On October 15, 2004, SunLink entered into a \$30,000 five-year senior secured credit facility comprised of a revolving line of credit of up to \$15,000 with an interest rate at LIBOR plus 2.91%, a \$10,000 term loan (SunLink Term Loan A) with an interest rate at LIBOR plus 3.91% and a \$5,000 term loan facility (SunLink Term Loan B) with an interest rate at LIBOR plus 3.91%. The revolving line of credit and the SunLink Term Loan A were immediately available to the Company as of October 15, 2004. The SunLink Term Loan A was fully drawn on October 15, 2004. The SunLink Term Loan B closed on November 15, 2004. The \$10,000 SunLink Term Loan A and draws under the \$5,000 SunLink Term Loan B are repayable based on a 15-year amortization from the date of draw with final balloon payments due at the end of the

five-year maturity of the credit facility. The total availability under all components of the credit facility is keyed to the level of SunLink's earnings, which would have provided for current total borrowing capacity at March 31, 2007 of approximately \$27,633. Debt outstanding under the facility as of March 31, 2007 was the SunLink Term Loan A of \$8,389 and \$4,400 of the revolving line of credit. SunLink may use the remaining funds available from the revolving line of credit for hospital capital projects, equipment purchases and for working capital needs. Borrowing under the \$5,000 SunLink Term Loan B may be used, subject to satisfaction of certain covenants, to satisfy certain specified claims and obligations, to fund acquisitions or to reacquire the Company's securities. The credit facility is secured by a first priority security interest in all assets and properties, real and personal, of the Company and its consolidated domestic subsidiaries, including a pledge of all of the equity interests in such subsidiaries.

If SunLink or its applicable subsidiaries experience a material adverse change in its or their business, assets, financial condition, management or operations, or if the value of the collateral securing the SunLink Credit Facility decreases, we may be unable to draw on such credit facility.

We believe attractive and up-to-date physical facilities assist in recruiting quality staff and physicians, as well as attracting patients. We expended \$5,776 for capital improvements at our hospitals during the nine months ended March 31, 2007 and also had \$1,230 in accounts payable for capital expenditures accepted prior to the quarter end. The Company has also begun a major renovation project at our Dahlonega, Georgia, facility and a free standing diagnostic center in Dawsonville, Georgia, which has a combined estimated cost of approximately \$6,900, of which approximately \$1,700 of cost has been paid or accrued to date and of which approximately \$1,900 additional costs are expected to be paid or accrued by the end of the current fiscal year. There are no other material future commitments for capital expenditures except for the Dahlonega, Georgia major renovation and the Dawsonville, Georgia, free standing diagnostic center projects. In April, 2007, the Company filed Certificate of Need application with the state of Georgia to build a replacement hospital in Ellijay, Georgia. No action has been taken on the application and to date SunLink has made no commitments related to the replacement hospital. SunLink currently expects to spend approximately \$2,500 in capital expenditures (in addition to the \$1,230 in accounts payable at quarter end) during the remaining three months of the fiscal year ending June 30, 2007, primarily for the hospital expansion project and new and replacement equipment.

SunLink's strategy is to focus its efforts on internal growth of its seven hospitals supplemented by growth from selected acquisitions. Subject to the availability of debt and/or equity capital, SunLink's future growth may include replacement or expansion of its existing hospitals involving substantial capital expenditures, as well as the expenditure of significant amounts of capital for selected hospital acquisitions.

We believe we have adequate financing and liquidity to support our current level of operations through the next twelve months. Our primary sources of liquidity are cash generated from continuing operations and availability under the SunLink Credit Facility. The total availability of credit under all components of the SunLink Credit Facility is keyed to the level of SunLink's earnings, which, based upon the Company's estimates, would provide for current borrowing capacity, before any draws, of approximately \$27,633 at March 31, 2007, of which \$8,389 was outstanding under a term loan and \$4,400 outstanding under a revolving line of credit. The current remaining availability of approximately \$14,844 could be adversely affected by, among other things, lower earnings due to lower demand for our services by patients, change in patient mix and changes in terms and levels of government and private reimbursement for services. Cash generated from operations could be adversely affected by, among other things, lower patient demand for our services, higher operating costs (including, but not limited to, salaries, wages and benefits, provisions for bad debts, general liability and other insurance costs, cost of pharmaceutical drugs and other operating expenses) or by changes in terms and levels of government and private reimbursement for services, and the regulatory environment of the community hospital segment.

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases, physician guarantees and interest on outstanding debt from continuing operations at March 31, 2007 were as follows:

| Payments due in: | Long-Term Debt | Operating Leases | Physician Guarantees | Interest on Outstanding Debt |
|-------------------------|-----------------------|-------------------------|-----------------------------|-------------------------------------|
| 1 year | \$ 868 | \$ 2,043 | \$ 972 | \$ 754 |
| 2 years | 750 | 1,691 | 182 | 685 |
| 3 years | 7,077 | 1,322 | | 319 |
| 4 years | | 866 | | |
| 5 years | | 489 | | |
| More than 5 years | | 1,748 | | |
| | \$ 8,695 | \$ 8,159 | \$ 1,154 | \$ 1,758 |

At March 31, 2007, SunLink had contracts with 9 physicians which contain guaranteed minimum gross receipts. Physician guarantee contracts entered into after January 1, 2006 are accounted for under the provisions of FSP FIN 45-3. See Note 5 Recent Accounting Pronouncements for discussion of FSP FIN 45-3. For guarantee contracts entered into prior to the adoption of FSP FIN 45-3, SunLink expenses physician guarantees as they are determined to be due to the physician on an accrual basis. Each month the physician's gross patient receipts are accumulated and the difference between the monthly guarantee and the physician's actual gross receipts for the month is calculated. If the guarantee is greater than the receipts, the difference is accrued as a liability and an expense. The net guarantee amount is paid to the physician in the succeeding month. If the physician's monthly receipts exceed the guarantee amount in subsequent months, then the overage is repaid to SunLink to the extent of any prior monthly guarantee payments and the liability and expense is reduced by the amount of the repayments. The physician with whom a guarantee agreement is made agrees to maintain their practice within the hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician's liability for any guarantee repayment due to non-compliance with guarantee provisions generally is collateralized by the physician's patient accounts receivable and/or a promissory note from the physician. Included in the Company's consolidated balance sheet at March 31, 2007 is a liability of \$676 for 8 physician guarantees accounted for under the provisions of FSP FIN 45-3. SunLink expensed \$189 and \$420 for the three months ended March 31, 2007 and 2006, respectively, and expensed \$836 and \$1,305 for the nine months ended March 31, 2007 and 2006, respectively. The table above shows noncancelable commitments under physician guarantee contracts as of March 31, 2007.

In March 2007, one of the Company's hospitals received a past due tax statement from the Internal Revenue Service (IRS) demanding approximately \$832 for a civil penalty related to payroll taxes allegedly unpaid for the year ending December 31, 1999. The Company acquired this hospital in 2001. The hospital had earlier received a notice from the IRS in May 2006 about a payroll tax deficiency for calendar 1999, but after reviewing the payroll tax records for calendar 1999 provided by the IRS, the Company believes that all the payroll taxes, assessed penalties and related interest for calendar 1999 have been paid by the hospital and that no amounts should be due. The Company has written the IRS to obtain an explanation of this civil penalty and to obtain a resolution of this matter. No response from the IRS has been received. The Company does not have any amount accrued for this matter at March 31, 2007 as it does not believe any taxes are due for the year ended December 31, 1999, nor is the Company aware of any matter that would cause a civil penalty to be levied.

SunLink became self-insured for employee health risks on October 1, 2006. For the period October 1, 2005 to September 30, 2006, SunLink had a fully-insured employee health insurance plan.

At March 31, 2007, we had outstanding long-term debt of \$8,695 of which \$8,389 was incurred in connection with the SunLink Credit Facility and \$306 was related to capital leases. Also outstanding at March 31, 2007 was a revolving line of credit loan of \$4,400.

Discontinued Operations

SunLink sold its former U.K. housewares manufacturing subsidiary, Beldray Limited (Beldray), to two of its managers in October 2001. Beldray has since entered into administrative receivership and is under the administration of its primary lender. SunLink believes Beldray ceased to operate in October 2004.

As previously disclosed in the notes to our financial statements, KRUG International U.K. Ltd. (KRUG UK), an inactive U.K. subsidiary of SunLink, entered into a guarantee (the Beldray Guarantee), at a time when it owned Beldray. The Beldray Guarantee covers Beldray s obligations under a lease of a portion of Beldray s former manufacturing facility. On October 2004, KRUG UK received correspondence from the landlord of such facility stating that the rent payment of 94,000 British pounds (\$181) for the fourth quarter of 2004 had not been paid by Beldray and requesting payment of such amount pursuant to the Beldray Guarantee. In January 2005, KRUG UK received further correspondence from the landlord demanding two quarterly rent payments totaling 188,000 British pounds (\$362) under the Beldray Guarantee. In January 2005, the landlord filed a petition in the High Court of Justice Chancery Division to wind up KRUG UK under the provisions of the Insolvency Act of 1986 and KRUG UK was placed into involuntary liquidation by the High Court in February 2005. After that date, the court-appointed liquidator of KRUG UK has made certain inquiries to SunLink regarding the activities of KRUG UK prior to the liquidation to which SunLink has responded.

SunLink s non-current liability reserves for discontinued operations at March 31, 2007, included a reserve for a portion of the Beldray Guarantee. Such reserve was based upon management s estimate, after consultation with its property consultants and legal counsel, of the cost to satisfy the Beldray Guarantee in light of KRUG UK s limited assets and before taking into account any other claims against KRUG UK. The maximum potential obligation of KRUG UK for rent under the Beldray Guarantee is estimated to be approximately \$8,400. As a result of this claim and the U.K. liquidation proceedings against KRUG UK, SunLink expects KRUG UK to be wound-up in liquidation in the UK and has fully reserved for any assets of KRUG UK.

Additional contingent obligations, other than with respect to our existing operations, include potential product liability claims for products manufactured and sold before the disposal of our discontinued industrial segment in fiscal 1989, remaining obligations of Mountainside Medical Center, the operating assets of which the Company sold in 2004, guarantees of certain obligations of former subsidiaries. We have one United Kingdom subsidiary in involuntary liquidation and two inactive European subsidiaries. Based upon an evaluation of information currently available and consultation with legal counsel, management has not reserved any amounts for contingencies related to these liquidations.

Legal Proceedings

See Part II. Item 1. Legal Proceedings of this Form 10-Q.

Sarbanes-Oxley Section 404

We are currently in the process of planning for the evaluation, documentation and testing of our internal control systems in order to permit our management to be in a position to report on, and our independent auditors to attest to, our internal controls over financial reporting as of June 30, 2008, as required by Section 404 of the Sarbanes-Oxley Act of 2002 (*Sarbanes-Oxley*). As a consequence, we anticipate incurring additional expenses in the fiscal year ending June 30, 2007 and substantial additional expenses in the subsequent fiscal years as well as diverting substantial time of the Company's management and Board of Directors to this task. While we currently are planning for timely completion of such documentation, testing and evaluation, there can be no assurance that we will be able to implement the requirements of Section 404 of Sarbanes-Oxley with adequate compliance by June 30, 2008. Should we be unable to do so, we could be subjected to investigation by regulatory authorities, incur litigation costs and/or suffer loss of our AMEX listing. Any such actions could adversely affect our financial results and/or the market price of our common shares.

We incurred incremental costs related to compliance with Sarbanes-Oxley during the nine months ended March 31, 2007. We anticipate that these costs will increase and become significant in future periods. Specifically, the cost of compliance with the Sarbanes-Oxley requirements is expected to result in increased operating expenses during the fiscal year ending June 30, 2007 and subsequent fiscal years. Although we do not currently have specific estimates of these costs, the cost of the initial implementation as well as on-going compliance with Section 404 could be particularly high for the Company due to its decentralized management structure.

Recent Accounting Pronouncements

In November 2005, the Financial Accounting Standards Board (*FASB*) issued FASB Staff Position (*FSP*) No. 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners* (*FSP FIN 45-3*). The guidance in this staff position amends FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (*FIN 45*) by adding minimum revenue guarantees to the list of example contracts to which FIN 45 applies. Under FSP FIN 45-3, a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. One example cited in FSP FIN 45-3 involves a guarantee provided by a healthcare entity to a non-employed physician in order to recruit such physician to move to the entity's geographical area and establish a private practice. In the example, the healthcare entity also agreed to make payments to the relocated physician if the gross revenue or gross receipts generated by the physician's new practice during a specified time period did not equal or exceed predetermined monetary thresholds.

FSP FIN 45-3 is effective for new minimum revenue guarantees issued or modified on or after January 1, 2006. The Company adopted FSP FIN 45-3 effective January 1, 2006. SunLink's accounting policy for physician guarantees issued prior to January 1, 2006 was to expense guarantees as they were paid. However, under FSP FIN 45-3, the Company expenses the advances paid to physicians over the period of the physician recruiting agreement, which is typically two to three years. The expense recorded for physician guarantees accounted for under FSP FIN 45-3 during the nine months ended March 31, 2007 was \$587 less than would have been expensed using the Company's previous accounting policy.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments -an amendment of FASB Statements No. 133 and 140*, which simplifies

accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid instrument that contains an embedded derivative that otherwise would require bifurcation and eliminates a restriction on the passive derivative instruments that a qualifying special-purpose entity may hold. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this Statement is not expected to have a material impact on our consolidated results of operations or our consolidated financial position.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140*, which establishes, among other things, the accounting for all separately recognized servicing assets and servicing liabilities by requiring that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits the entity to choose either the amortization method or fair value method for subsequent measurement. SFAS No. 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of SFAS No. 156 is not expected to have a material impact on our consolidated results of operations or our consolidated financial position.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*, which establishes that the financial statement effects of a tax position taken or expected to be taken in a tax return are to be recognized in the financial statements when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect of adopting FIN 48 on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the effect of adopting SFAS No. 157 on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements Nos. 87, 88, 106, and 132(R)*, which requires a business entity to recognize the overfunded or underfunded status of a single-employer defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in comprehensive income in the year in which the changes occur. SFAS No. 158 also requires a business entity to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The Company is required to adopt this Statement as of the end of the fiscal year ended June 30, 2007. There is projected to be no effect on the consolidated statement of earnings from the adoption of this statement. We expect that the pension asset recognized in the consolidated balance sheet will be reduced by an offsetting amount in shareholders' equity in the accumulated other comprehensive loss. If this Statement had been adopted by the Company at June 30, 2006, pension asset and shareholders' equity would have been reduced by \$456, the amount of the unrecognized actuarial loss at June 30, 2006 determined under FASB Statement No. 87.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. It also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the effect of adopting SFAS No. 159 on the Company's consolidated financial statements.

In September 2006, the U.S. Securities and Exchange Commission (SEC) staff added Section N to Staff Accounting Bulletin (SAB) Topic 1 through the issuance of SAB 108 - *Financial Statements - Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 addresses how a company should evaluate whether an error in its financial statements is material. The guidance in SAB 108 will be effective for annual financial statements with fiscal years ending after November 15, 2006. The Company is currently evaluating the impact of adopting SAB 108 on the Company's consolidated financial statements.

Related Party Transactions

A director of the Company and our company secretary (who was a director of SunLink until November 2003 and is now a director emeritus) are members of two different law firms, each of which provides services to SunLink. The Company has paid an aggregate of \$427 for legal services to these law firms in the nine months ended March 31, 2007.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to interest rate changes, primarily as a result of borrowing under our credit facility. At March 31, 2007, borrowings under the facility of \$12,789 have been drawn at an interest rate based upon LIBOR. A one percent change in the LIBOR rate would result in a change in interest expense of \$128 on an annual basis. No action has been taken to mitigate our exposure to interest rate market risk and we are not a party to any interest rate market risk management activities.

ITEM 4. CONTROLS AND PROCEDURES

Management of the Company, with the participation and under the supervision of the Company's Chief Executive Officer and Interim Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report. Based on this evaluation the Chief Executive Officer and Interim Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective as of the end of the period covered by this periodic SEC filing to provide reasonable assurance that material information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission's rules and forms. There has been one change in the Company's internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company's management, including its Chief Executive Officer and Interim Chief Financial Officer, does not expect that the Company's disclosure controls and internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include, among others, the realities that judgments in decision-making can be faulty, that breakdowns can occur because of simple error or mistake and that personnel turnover may leave gaps in controls. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control.

The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, a control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

In connection with the review of our Quarterly Report on Form 10-Q for the quarter ending March 31, 2007, our independent registered public accounting firm identified a significant deficiency. A significant deficiency is a control deficiency, or a combination of control deficiencies that adversely affects an entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. GAAP such that there is more than a remote likelihood that a misstatement of the entity's annual or interim financial statements that is more than inconsequential will not be prevented or detected. Our independent registered public accounting firm identified as a significant deficiency the fact that, because SunLink does not currently have a corporate controller, there is no detail review of the consolidating worksheet, analyses and periodic filing prepared by SunLink's Interim Chief Financial Officer. Our independent registered public accounting firm did not identify any material weakness and our management did not identify any material weakness. Our independent registered public accounting firm has recommended that we hire, and we are currently seeking to hire, an additional employee with the background and skills to perform duties typical of a corporate controller. We intend to continue to evaluate and, when appropriate, enhance our disclosure controls and procedures, including our internal control over financial reporting.

PART II. OTHER INFORMATION

Items required under Part II not specifically shown below are not applicable.

ITEM 1. LEGAL PROCEEDINGS

On July 13, 2006, Piedmont Healthcare, Inc. (PHI) and Piedmont Mountainside Hospital, Inc. (PMH) (collectively the Plaintiffs or Piedmont) filed a Complaint in the Superior Court of Cobb County, Georgia, alleging breach of the Asset Purchase Agreement (the Agreement) dated as of April 9, 2004 by and among PMH, Piedmont Medical Center, Inc. (n/k/a PHI), Southern Health Corporation of Jasper, Inc. (SHCJ), SunLink Healthcare LLC (formerly SunLink Healthcare Corp.) and SunLink (collectively Defendants or SunLink) pursuant to which the Mountainside Medical Center was sold to PMH in June 2004. Specifically, Piedmont seeks to have SunLink reimburse Piedmont for certain costs associated with an alleged indigent and charity care shortfall of Piedmont Mountainside Hospital (formerly Mountainside Medical Center) for the fiscal year ended June 30, 2004 demanded by the Georgia Department of Community Health (DCH). In addition, Piedmont seeks reimbursement for funds allegedly recouped from PMH by DCH in respect of Medicaid Cost Report settlements and adjustments for the reporting periods ended June 30, 2002, June 30, 2003 and May 31, 2004. Piedmont also seeks a declaratory judgment to the effect that PMH may retain certain payments it has received or likely will receive from the DCH s Indigent Care Trust Fund for Disproportionate Share Hospitals. Piedmont also seeks recovery of costs and attorney s fees pursuant to the Agreement and under Georgia Law.

On August 11, 2006, SunLink filed an Answer to the complaint asserting factual and legal defenses, along with a Counterclaim. In the Counterclaim, SHCJ alleges that PMH breached the Agreement by failing to reimburse SHCJ for certain Medicaid Cost Report adjustments for the reporting period ended June 30, 1999, and June 30, 2000, as well as funds paid or expected to be paid to PMH from the DCH s Indigent Care Trust Fund for Disproportionate Share Hospitals, which payments Defendants contend qualify as excluded assets not sold to PMH under the Agreement. SHCJ also alleged that PMH breached the Agreement by failing to cooperate with SHCJ in an appeal of certain Medicaid Cost Reports settlements for the reporting periods ended June 30, 2002, June 30, 2003 and May 31, 2004. SHCJ further alleged that Piedmont breached its obligations to guaranty PMH s payment and performance of its obligations under the Agreement. SunLink seeks a declaratory judgment regarding the parties rights in respect of the Medicaid Cost Report settlements and adjustments, as well as the payments made and expected to be made under the Indigent Care Trust Fund. Finally, SunLink seeks to recover their costs and attorney s fees pursuant to the Agreement and under Georgia law.

SunLink denies that it has any liability to the Plaintiffs and intends to vigorously defend the claims asserted against SunLink in connection with the Complaint. While the ultimate outcome and materiality of the Complaint cannot be determined, in management s opinion the Complaint will not have a material adverse effect on SunLink s financial condition or results of operations.

SunLink is a party to claims and litigation incidental to its business, for which it is not currently possible to determine the ultimate liability, if any. Based on an evaluation of information currently available and consultation with legal counsel, management believes that resolution of such claims and litigation is not likely to have a material effect on the financial position, cash flows, or results of operations of the Company. The Company expenses legal costs as they are incurred.

ITEM 1A. RISK FACTORS

Risk Factors Relating to an Investment in SunLink

Information regarding risk factors appears in MD&A Forward-Looking Statements, in Part I Item 2 of this Form 10-Q and in MD&A -Risks Factors Relating to an Investment in SunLink in Part I Item 1A. of the Company's Annual Report on Form 10-K for the year ended June 30, 2006. While we believe there have been no material changes from the risk factors previously disclosed in such Annual Report, except as discussed in MD&A Corporate Business Strategy and MD&A Discontinued Operations in Item 2 of this Form 10-Q, you should carefully consider, in addition to the other information set forth in this report, the risk factors discussed in our Annual Report which could materially affect our business, financial condition or future results. Such risk factors are expressly incorporated herein by reference. The risks described in our Annual Report are not the only risks facing our Company. In addition to risks and uncertainties inherent in forward looking statements contained in this Report on Form 10-Q, additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. Whenever we refer to SunLink, we, our, or us in this Item 1A, we mean SunLink Health Systems, Inc. and its subsidiaries, unless the context suggests otherwise.

ITEM 6. EXHIBITS

Exhibits:

- 31.1 Chief Executive Officer's Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
- 31.2 Chief Financial Officer's Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
- 32.1 Chief Executive Officer's Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Chief Financial Officer's Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

SunLink Health Systems, Inc.

By: /s/ Mark J. Stockslager
Mark J. Stockslager

Interim Chief Financial Officer

Dated: May 15, 2007