SUNLINK HEALTH SYSTEMS INC
Form 10-Q
November 13, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from ______ to ______

Commission File Number 1-12607

SUNLINK HEALTH SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Ohio	**31-0621189**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer 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 x 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.

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

The number of Common Shares, without par value, outstanding as of November 9, 2006 was 7,343,120.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

	September 30, 2006	June 30, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 826	$ 1,084
Receivables - net	16,522	16,494
Medical supplies	2,886	2,577
Deferred income tax asset	5,275	5,391
Prepaid expenses and other	3,538	2,363
Total Current Assets	29,047	27,909
Property, Plant and Equipment, at cost	53,328	51,800
Less accumulated depreciation and amortization	11,619	10,645
Property, Plant and Equipment - net	41,709	41,155
Goodwill	2,944	2,944
Other assets	2,599	2,295
Total Assets	$ 76,299	$ 74,303
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 7,450	$ 7,689
Revolving advances	2,646	
Third-party payor settlements	4,429	3,666
Current maturities of long-term debt	910	928
Accrued payroll and related taxes	4,921	5,231
Income taxes		211
Current liabilities of Mountainside Medical Center	601	1,528
Other accrued expenses	3,376	3,042
Total Current Liabilities	24,333	22,295
Long-Term Liabilities:		
Long-term debt	8,248	8,465
Noncurrent liability for professional liability risks	2,425	3,281
Noncurrent deferred income tax liabilities	4,161	4,025
Other noncurrent liabilities	2,033	1,885
Total Long-term Liabilities	16,867	17,656
Commitments and Contingencies		
Shareholders Equity:		

Preferred shares, authorized and unissued, 2,000 shares Common shares, without par value:			
Issued and outstanding, 7,343 shares at September 30, 2006 and 7,315 shares at June 30, 2006		3,672	3,658
Additional paid-in capital		8,573	8,393
Retained earnings		23,095	22,545
Accumulated other comprehensive loss		(241)	(244)
Total Shareholders Equity		35,099	34,352
Total Liabilities and Shareholders Equity	$	76,299	$ 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 September 30, 2006	2005
Net Revenues	$ 34,483	$ 33,899
Cost of Patient Service Revenues:		
Salaries, wages and benefits	17,711	16,175
Provision for bad debts	4,693	3,868
Supplies	3,749	3,622
Purchased services	2,164	2,150
Other operating expenses	3,353	4,753
Rent and lease expense	725	618
Depreciation and amortization	1,026	768
Cost of patient service revenues	33,421	31,954
Operating Profit	1,062	1,945
Other Income (Expense):		
Interest expense	(317)	(275)
Interest income	8	20
Earnings From Continuing Operations before Income Taxes	753	1,690
Income Tax Expense	285	606
Earnings From Continuing Operations	468	1,084
Earnings from Discontinued Operations	82	19
Net Earnings	$ 550	$ 1,103
Earnings Per Share:		
Continuing Operations:		
Basic	$ 0.06	$ 0.15
Diluted	$ 0.06	$ 0.14
Discontinued Operations:		
Basic	$ 0.01	$ 0.00
Diluted	$ 0.01	$ 0.00
Net Earnings:		
Basic	$ 0.08	$ 0.15
Diluted	$ 0.07	$ 0.14

Weighted-Average Common Shares Outstanding:		
Basic	7,328	7,205
Diluted	7,830	7,791

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	THREE MONTHS ENDED September 30, 2006	2005
Net Cash Provided By (Used In) Operating Activities	$ (1,178)	$ 3,083
Cash Flows From Investing Activities:		
Expenditures for property, plant and equipment	(1,546)	(1,302)
Net Cash Used in Investing Activities	(1,546)	(1,302)
Cash Flows From Financing Activities:		
Proceeds from issuance of common shares under stock option plans	55	113
Revolving advances, net	2,646	
Payments on long-term debt	(235)	(225)
Net Cash Provided by (Used in) Financing Activities	2,466	(112)
Net Increase (Decrease) in Cash and Cash Equivalents	(258)	1,669
Cash and Cash Equivalents at Beginning of Period	1,084	5,281
Cash and Cash Equivalents at End of Period	$ 826	$ 6,950
Supplemental Disclosure of Cash Flow Information:		
Cash Paid For:		
Interest	$ 308	$ 271
Income taxes	$ 523	$ 846
Non-cash investing and financing activities - Capital leases	$	$ 272

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED SEPTEMBER 30, 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 month period ended September 30, 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, filed with the September 18, 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 month period ended September 30, 2006 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 three months ended September 30, 2006, SunLink concentrated its efforts on the operations 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. SunLink s evaluation of such alternatives is currently ongoing.

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 September 30, 2006	2005
Earnings from discontinued operations:		
Mountainside Medical Center:		
Earnings from operations	$ 147	$ 38
Income tax expense	56	13
Earnings from Mountainside Medical Center after taxes	91	25
Life sciences and engineering segment:		
Loss from operations	(14)	(6)
Income tax benefit	(5)	
Loss from Life sciences and engineering segment after taxes	(9)	(6)
Earnings from discontinued operations	$ 82	$ 19

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 earnings in the quarter ended September 30, 2006 resulted primarily from $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 months ended September 30, 2006 and 2005, respectively, were the following:

	Three Months Ended September 30, 2006	2005
Service cost	$	$
Interest cost	19	23
Expected return on assets	(12)	(22)
Amortization of prior service cost	7	5
Net pension expense	$ 14	$ 6

SunLink did not contribute to the plan in the three months ended September 30, 2006. We expect to contribute $150 to the plan through the end 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 September 30, 2006, 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 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 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 September 30, 2006 and 2005 was an increase of $139 and $57, 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 June 2005, FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3.* This statement applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable. APB Opinion No. 20 previously required that most voluntary changes in accounting principles be recognized by including in net income for the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 is intended to improve financial reporting because its requirements enhance the consistency of financial information between periods. SFAS No. 154 requires that a change in method of depreciation, amortization, and depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. APB Opinion No. 20 previously required that such a change be reported as a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of SFAS No. 154. Implementation of this Standard did not have a material impact on the consolidated financial statements of the Company.

In November 2005, the 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 will expense the advances paid to physicians over the period of the physician recruiting agreement, which is typically two to three years. The effect of the adoption of FSP FIN 45-3 during the three months ended September 30, 2006 was a reduction of expense of $163.

In November 2005, FASB issued FSP Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other Than Temporary Impairment and its Application to Certain Investments* . This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of the impairment loss. This FSP became effective for periods beginning after December 15, 2005. Implementation of this guidance did not have any impact on the consolidated financial statements of the Company.

In February 2006, FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140*. This Statement amends FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities* , and No. 140*, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* . This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*. This Statement:

a. Permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation;

b. Clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133;

c. Establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation;

d. Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and

e. Amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

This statement is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Implementation of this Standard is not expected to have a material impact on the consolidated financial statements of the Company.

In March 2006, FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* . The new Standard, which is an amendment to FAS No. 140, will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, the new Standard addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting.

The Standard also:

1. Clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability.

2. Requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable.

3. Permits an entity with a separately recognized servicing asset or servicing liability to choose either of the following methods for subsequent measurement:

    a. Amortization Method

    b. Fair Value Method

FAS No. 156 permits a servicer that uses derivative financial instruments to offset risks on servicing to report both the derivative financial instrument and related servicing asset or liability by using a consistent measurement attribute fair value. This Standard is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Implementation of this Standard is not expected to have a material impact on the consolidated financial statements of the Company.

In June 2006, FASB published FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 attempts to clarify the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes.* This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is recognition: The company determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one of the following:

a. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable

b. A reduction in a deferred tax asset or an increase in a deferred tax liability

c. Both (a) and (b).

A company that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year or the operating cycle, if longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this Interpretation and its reported amount in the statement of financial position). This Interpretation does not change the classification requirements for deferred taxes.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in SFAS No. 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this Interpretation. This Interpretation is effective for fiscal years beginning after December 15, 2006. Its adoption by the Company is not expected to have a material impact on the Company s consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* . This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities the application of this statement will change current practice. Under the statement, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. The statement clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing the asset or liability. In support of this principle, the statement establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity s own data. Under the statement, fair value measurements would be separately disclosed by level within the fair value hierarchy. 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 Post-retirement Plans an amendment of FASB Statements No.87, 88, 106 and 132(R)* . This standard requires an employer to:

(a) Recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status

(b) Measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions)

(c) Recognize changes in the funded status of a defined benefit post-retirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity and in changes in net assets of a not-for-profit organization.

This Statement amends FASB Statement No. 87, *Employers Accounting for Pensions* , Statement No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* , Statement 106, *Employers Accounting for Post-retirement Benefits other than Pensions* , and Statement No. 132 (revised 2003), *Employers Disclosures about Pensions and Other Postretirement Benefits* , and other related accounting literature. Upon initial application of this Statement and subsequently, an employer should continue to apply the provisions in Statements No. 87, No. 88, and No. 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

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 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 Financial Statements - Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). 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 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:

	September 30, 2006	June 30, 2006
Patient accounts receivable (net of contractual allowances)	$ 26,193	$ 25,425
Less allowance for doubtful accounts	(9,671)	(8,931)
Receivables - net	$ 16,522	$ 16,494

Net revenues included increases of $45 and $720 for the three months ended September 30, 2006 and 2005, 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:

	September 30, 2006	June 30, 2006
SunLink Term Loan A	$ 8,722	$ 8,889
Capital lease obligations	436	504
	9,158	9,393
Less current maturities	(910)	(928)
	$ 8,248	$ 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 September 30, 2006 of approximately $28,722. Debt outstanding under the facility as of September 30, 2006 was the SunLink Term Loan A of $8,722 and $2,646 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. Costs and fees related to execution of the credit facility were $916. 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 $285 ($270 federal tax expense and $15 state tax expense) and $606 ($455 federal tax expense and $151 state tax expense) was recorded for the three months ended September 30, 2006 and 2005, respectively. The $270 federal tax expense for the three months ended September 30, 2006 included $214 deferred income tax expense. The $455 federal tax expense for the three months ended September 30, 2005 included $370 deferred income tax expense. We had an estimated net operating loss carry-forward for federal income tax purposes of approximately $7,800 at September 30, 2006. 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 September 30, 2006, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was $1,114. 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 September 30, 2006	September 30, 2005
Net earnings	$ 550	$ 1,103
Other comprehensive income net of tax:		
Change in equity due to :		
Foreign currency Translation adjustments	(3)	22
Comprehensive earnings	$ 547	$ 1,125

Note 10. - Commitments and Contingencies

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 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 from the reporting periods ending 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 ending 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 ending 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.

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 September 30, 2006, 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.

Hospital Information Systems

By the end of calendar 2006, we expect to have substantially completed the conversion of our hospitals to a single management information system. Prior to the initial conversion, we previously utilized three different management information systems at our seven hospitals. Five hospitals utilized comprehensive systems designed for larger hospitals and two hospitals utilize a system designed for smaller hospitals. In June 2005, SunLink entered into a license and support agreement with a management information system company for a single management information system for our seven hospitals with an estimated cost of $2,800 for software, installation, training and support. In July 2005, SunLink entered into a capital lease for computer and other hardware for the new system with a commitment of approximately $275. The total cost of the software licenses, hardware, installation and training for the new management information system is estimated to be $3,500, approximately $3,200 of which is expected to be capitalized and amortized over the useful life of the new system, which is 4 years for hardware and 7 years for the licenses and installation.

Other

As of September 30, 2006, SunLink had no material future commitments for capital expenditures except for the management information system conversion project discussed in the previous paragraph. Subject to the availability of internally generated funds and other financing, SunLink currently expects to spend approximately $4,500 in capital expenditures, primarily new and replacement equipment, during the remaining nine months of the fiscal year ending June 30, 2007, primarily for new and replacement equipment and the management information system conversion project.

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 internal 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 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.

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 September 30, 2006 were as follows:

	Long-Term Debt	Operating Leases	Physician Guarantees	Interest on Outstanding Debt
Payments due in:				
1 year	$ 910	$ 2,221	$ 1,544	$ 792
2 years	811	1,584	50	719
3 years	709	1,188		653
4 years	6,728	624		5
5 years		482		
More than 5 years		1,840		
	$ 9,158	$ 7,939	$ 1,594	$ 2,169

At September 30 2006, SunLink had contracts with 8 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 collaterized by the physician s patient accounts receivable and/or a promissory note from the physician. Included in Company s consolidated balance sheet at September 30, 2006 is a liability of $965 for 5 physician guarantees accounted for under the provisions of FSP FIN 45-3. SunLink expensed $345 and $419 for the three months ended September 30, 2006 and 2005, respectively. The table above shows noncancelable commitments under physician guarantee contracts as of September 30, 2006.

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 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;

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;

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

increases in wages 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

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 recent prices paid by others 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 transaction. SunLink s evaluation of such alternatives is currently ongoing.

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:

- Receivable 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 September 30, 2006	2005	% Change
Net revenues	$ 34,483	$ 33,899	1.7%
Cost of patient service revenues	(33,421)	(31,954)	4.6%
Operating profit	1,062	1,945	(45.4)%
Interest expense	(317)	(275)	15.3%
Interest income	8	20	(60.0)%

Earnings from Continuing Operations before Income Taxes	$ 753	$ 1, 690	(55.4)%
Admissions	2,374	2,584	(8.1)%
Equivalent Admissions	6,668	6,582	1.3%
Surgeries	1,227	1,220	0.6%
Revenue per Equivalent Admission	$ 5,171	$ 5,150	0.4%

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 September 30, 2006 were $34,483 with a total of 6,668 equivalent admissions and revenue per equivalent admission of $5,171 compared to net revenues of $33,899, a total of 6,582 equivalent admissions and revenue per equivalent admission of $5,150 for the quarter ended September 30, 2005. The 1.7% increase in net revenues for the quarter ended September 30, 2006 was due to a 1.3% increase in equivalent admissions, a 0.6% increase in surgeries and a 0.4% increase in net revenue per equivalent admission. Commercial insurance and other payor net revenues increased 8.5% in the current year s quarter. Net outpatient service revenues increased $1,723, an 11.2% increase from last year to $17,083 for the three months ended September 30, 2006 and increased to 49.5% of net revenues from 45.3% last year. Net revenue for the three months ended September 30, 2006 and 2005, included $406 and $160, respectively, from state indigent care programs. Net revenues included $45 and $720 for the three months ended September 30, 2006 and 2005, 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 three net new doctors during the three months ended September 30, 2006. During the three months ended September 30, 2006, SunLink expensed $345 on physician guarantees and recruiting expenses compared to $419 for the same period last year. We also have expended approximately $9,558 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 months ended September 30, 2006 compared to the same period 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:

	Three Months Ended September 30,	
	2006	**2005**
Source		
Medicare	44.2%	44.6%
Medicaid	14.1%	16.7%
Self pay	9.4%	8.5%
Commercial Insurance & Other	32.3%	30.2%
	100.0%	100.0%

During the three months ended September 30, 2006, we have experienced a decrease in Medicare and Medicaid as a percentage of net revenues with an increase in Commercial Insurance and other revenues. In each case, the changes were due primarily to increased managed care patients. In absolute dollars, Medicare net revenues increased in the three months ended September 30, 2006, compared to the prior year, but the increases were at lower rates than the overall 1.7% increase in net revenues.

Cost of patient service revenues, including depreciation, was $33,421 and $31,954 for the three months ended September 30, 2006 and 2005, respectively.

	Cost of Patient Service Revenues As % of Net Revenues Three Months Ended September 30,	
	2006	2005
Salaries, wages and benefits	51.4%	47.7%
Provision for bad debts	13.6%	11.4%
Supplies	10.9%	10.7%
Purchased services	6.3%	6.3%
Other operating expenses	9.7%	14.0%
Rent and lease expense	2.1%	1.8%

Salaries, wages and benefits expense increased as a percentage of net revenues for the three months ended September 30, 2006 due to increased salaries and more staff and an $82 expense increase in the current year for share option compensation expense resulting from SFAS 123(R). Salaries and wages increased 12.0% in the current year s quarter compared to the same quarter a year ago. Provision for bad debts increased as a percent of net revenue in the current year due to increases in charges for services rendered that could not be collected, overall decreased collections as a percentage of revenues and higher self-pay net revenues for the three months ended September 30, 2006 as compared to the same period of the prior fiscal year. Payments for Medicare patients were withheld during the last 9 days of September 2006 due to the lack federal government funding. Self-pay net revenues increased approximately 12.4% in the quarter ended September 30, 2006 compared to the prior year. 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 number of patients qualifying for Medicaid services. Medicaid net revenues decreased approximately 14.2% in the quarter ended September 30, 2006 compared to the prior year. Other operating expenses decreased 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 quarter ended September 30, 2006 benefited from a $967 reduction due to reducing the actuarially-determined liability for professional liability risks.

Depreciation and amortization expense increased $258 for the three months ended September 30, 2006 compared to the comparable prior year period. The increase in the current year was due primarily to the approximately $9,558 of capital expenditures in the past 15 months.

Operating profit for the three months ended September 30, 2006 was $1,062 or 3.1% of net revenues compared to $1,945 or 5.7% of net revenues for the three months ended September 30, 2005. The lower positive settlements and filings of prior year Medicare and Medicaid cost reports, $45 in the current year s first quarter as opposed to $720 in last year s, contributed to the lower operating profit. The decrease in operating profit as a percentage of net revenues was also attributable to higher salaries, wages and benefits expense, increased provisions for bad debt and increased depreciation and amortization.

Interest expense was $317 and $275 for the three months ended September, 2006 and 2005, respectively. The higher interest expense in the current year was due to higher interest rates related to the SunLink Term Loan in the current year.

Income tax expense of $285 ($270 federal tax expense and $15 state tax expense) and $606 ($455 federal tax expense and $151 state tax expense) was recorded for the three months ended September 30, 2006 and 2005, respectively. The $270 federal tax expense for the three months ended September 30, 2006 included $214 deferred income tax expense. The $455 federal tax expense for the three months ended September 30, 2005 included $370 deferred income tax expense. We had an estimated net operating loss carry-forward for federal income tax purposes of approximately $7,800 at September 30, 2006. 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 September 30, 2006, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was $1,114. 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 $468 ($0.06 per fully diluted share) for the quarter ended September 30, 2006 compared to earnings from continuing operations of $1,084 ($0.14 per fully diluted share) for the comparable quarter last year. Decreased operating profit resulted in the lower earnings from continuing operations in the current year s quarter.

In the quarter ended September 30, 2006, the Company recorded in discontinued operations $189 of favorable pre-tax settlements of prior year Medicaid cost reports relating to its former Mountainside Medical Center for periods prior to SunLink s sale of Mountainside in 2004. The after-tax earnings from discontinued operations of $82 ($0.01 per fully diluted share) in the quarter ended September 30, 2006 resulted from the favorable settlements.

Net earnings were $550 ($0.07 per fully diluted share) in the quarter ended September 30, 2006 compared to net earnings of $1,103 ($0.14 per fully diluted share) in the quarter ended September 30, 2005.

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 a 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 to 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 adjusted for similar items or compute corporate overhead in the same manner. Net cash provided by (used in) operations for the quarters ended September 30, 2006 and 2005, 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 September 30, 2006	2005
SHL Facilities Adjusted EBITDA	$ 2,274	$ 3,505
HealthMont Facilities Adjusted EBITDA	840	283
Corporate overhead costs	(1,026)	(1,075)
Depreciation and amortization	1,026	768
Taxes and interest expense	(594)	(861)
Other non-cash expenses and net changes in operating assets and liabilities	(3,698)	463
Net cash provided by (used in) operations	$ (1,178)	$ 3,083

Liquidity and Capital Resources

We used $1,178 of cash from operating activities during the three months ended September 30, 2006 compared to $3,083 of cash generated during the comparable period last year. The cash used from operations in the current year resulted from $928 used for the reduction of the liabilities of Mountainside Medical Center, income tax payments of $523 and cash used for increased receivable, medical supplies and other assets and from decreased accounts payable during the three months, which were partially offset by the $550 of net earnings and $1,026 of depreciation and amortization for the period.

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 September 30, 2006 of approximately $28,722. Debt outstanding under the facility as of September 30, 2006 was the SunLink Term Loan A of $8,722 and $2,646 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. Costs and fees related to execution of the credit facility were $916. 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 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 expended $1,546 for capital improvements at our hospitals during the three months ended September 30, 2006. We believe attractive and up-to-date physical facilities assist in recruiting quality staff and physicians, as well as attracting patients. Subject to the availability of internally generated funds and other financing, we currently expect to expend approximately $4,500 for capital expenditures (including the capitalized cost of the new management information system) during the remaining nine months of the fiscal year ending June 30, 2007.

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 internal 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 $28,722 at September 30, 2006, of which $8,722 was outstanding under a term loan and $2,646 outstanding under a revolving line of credit. The current remaining availability of approximately $17,354 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 September 30, 2006 were as follows:

	Long-Term Debt	Operating Leases	Physician Guarantees	Interest on Outstanding Debt
Payments due in:				
1 year	$ 910	$ 2,221	$ 1,544	$ 792
2 years	811	1,584	50	719
3 years	709	1,188		653
4 years	6,728	624		5
5 years		482		
More than 5 years		1,840		
	$ 9,158	$ 7,939	$ 1,594	$ 2,169

At September 30 2006, SunLink had contracts with 8 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 the guarantee agreement is made agrees to maintain their practice within the hospital geographic area for a specific period (normally three years) or the doctor would 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 will be collaterized by the physician s patient accounts receivable and/or a promissory note from the physician. Included in Company s consolidated balance sheet at September 30, 2006 is a liability of $965 for 5 physician guarantees accounted for under the provisions of FSP FIN 45-3. SunLink expensed $345 and $419 for the three months ended September 30, 2006 and 2005, respectively. The table above shows noncancelable commitments under physician guarantee contracts as of September 30, 2006.

At September 30, 2006, we had outstanding long-term debt of $9,158 of which $8,722 was incurred in connection with the SunLink Credit Facility and $436 was related to capital leases. Also outstanding at September 30, 2006 was a revolving line of credit loan of $2,646.

By the end of calendar 2006, we expect to have substantially completed the conversion of our hospitals to a single management information system. Prior to the initial conversion, we utilized three different management information systems at our seven hospitals. Five hospitals utilized comprehensive systems designed for larger hospitals and two hospitals utilized a system designed for smaller hospitals. In June 2005, SunLink entered into a license and support agreement with a management information system company for a single management information system for our seven hospitals with an estimated cost of $2,800 for software, installation, training and support. In July 2005, SunLink entered into a capital lease for computer and other hardware for the new system with a commitment of approximately $275. The total cost of the software licenses, hardware, installation and training for the new management information system is estimated to be $3,500, approximately $3,200 of which is expected to be capitalized and amortized over the useful life of the new system, which is 4 years for hardware and 7 years for the licenses and installation.

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 September 30, 2006, 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 and claims and litigation incidental to our businesses for which it is impossible to determine their ultimate liability, if any, or which are immaterial in amount. 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

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 ending 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 ending 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 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.

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 substantial additional expenses in the fiscal year ending June 30, 2007 and 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 three months ended September 30, 2006. 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 June 2005, FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3.* This statement applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable. APB Opinion No. 20 previously required that most voluntary changes in accounting principles be recognized by including in net income for the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 is intended to improve financial reporting because its requirements enhance the consistency of financial information between periods. SFAS No. 154 requires that a change in method of depreciation, amortization, and depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. APB Opinion No. 20 previously required that such a change be reported as a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of SFAS No. 154. Implementation of this Standard did not have a material impact on the consolidated financial statements of the Company.

In November 2005, the 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 will expense the advances paid to physicians over the period of the physician recruiting agreement, which is typically two to three years. The effect of the adoption of FSP FIN 45-3 during the three months ended September 30, 2006 was a reduction of expense of $163.

In November 2005, FASB issued FSP Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other Than Temporary Impairment and its Application to Certain Investments* . This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of the impairment loss. This FSP became effective for periods beginning after December 15, 2005. Implementation of this guidance did not have any impact on the consolidated financial statements of the Company.

In February 2006, FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140*. This Statement amends FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.* This Statement:

a. Permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation;

b. Clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133;

c. Establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation;

d. Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and

e. Amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

This statement is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Implementation of this Standard is not expected to have a material impact on the consolidated financial statements of the Company.

In March 2006, FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*. The new Standard, which is an amendment to FAS No. 140, will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, the new Standard addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting.

The Standard also:

1. Clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability.

2. Requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable.

3. Permits an entity with a separately recognized servicing asset or servicing liability to choose either of the following methods for subsequent measurement:

    a. Amortization Method

    b. Fair Value Method

FAS No. 156 permits a servicer that uses derivative financial instruments to offset risks on servicing to report both the derivative financial instrument and related servicing asset or liability by using a consistent measurement attribute fair value. This Standard is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Implementation of this Standard is not expected to have a material impact on the consolidated financial statements of the Company.

In June 2006, FASB published FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48).* FIN 48 attempts to clarify the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes* . This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is recognition: The company determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one of the following:

a. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable

b. A reduction in a deferred tax asset or an increase in a deferred tax liability

c. Both (a) and (b).

A company that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year or the operating cycle, if longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this Interpretation and its reported amount in the statement of financial position). This Interpretation does not change the classification requirements for deferred taxes.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in SFAS No. 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this Interpretation. This Interpretation is effective for fiscal years beginning after December 15, 2006. Its adoption by the Company is not expected to have a material impact on the Company s consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities the application of this statement will change current practice. Under the statement, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. The statement clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity s own data. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. 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 Post-retirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. This standard requires an employer to:

(a) Recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status

(b) Measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions)

(c) Recognize changes in the funded status of a defined benefit post-retirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity and in changes in net assets of a not-for-profit organization.

This Statement amends FASB Statement No. 87, *Employers Accounting for Pensions*, Statement No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, FASB Statement No. 106, *Employers Accounting for Post-retirement Benefits other than Pension*, and Statement No. 132 (revised 2003), *Employers Disclosures about Pensions and Other Postretirement Benefits*, and other related accounting literature. Upon initial application of this Statement and subsequently, an employer should continue to apply the provisions in Statements 87, 88, and 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

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 for 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 be have been reduced by $456, the amount of the unrecognized actuarial loss at June 30, 2006 determined under FASB Statement No. 87.

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 Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 addresses how a company should evaluate whether an error in its financial statements is material. The guidance in SAB 108 will be effect for 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 $132 for legal services to these law firms in the three months ended September 30, 2006.

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 completed in October 2004. At September 30, 2006, borrowings under the facility of $11,368 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 $114 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 no 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 the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. 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.

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 ending 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.

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: November 13, 2006