RAMCO GERSHENSON PROPERTIES TRUST
Form S-3
June 09, 2011

As filed with the Securities and Exchange Commission on June 9, 2011

Registration No. 333-

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

FORM S-3
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933
RAMCO-GERSHENSON PROPERTIES TRUST
(Exact name of registrant as specified in its charter)

Maryland	**13-6908486**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

31500 Northwestern Highway, Suite 300
Farmington Hills, MI 48334
(248) 350-9900
(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

Dennis Gershenson
President and Chief Executive Officer
Ramco-Gershenson Properties Trust
31500 Northwestern Highway, Suite 300
Farmington Hills, MI 48334
(248) 350-9900
(Name, address, including zip code, and telephone number, including area code, of agent for service of process)

Copy to:
Donald J. Kunz, Esq.
Honigman Miller Schwartz and Cohn LLP
2290 First National Building
660 Woodward Ave.
Detroit, Michigan 48226-3506
(313) 465-7454 (telephone)
(313) 465-7455 (facsimile)

Approximate date of commencement of proposed sale to the public: From time to time after the effective date of this registration statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered in connection with dividend or interest reinvestment plans, check the following box. þ

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box. o

If this Form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered (1)	Proposed Maximum Offering Price Per Unit(1)(2)	Proposed Maximum Aggregate Offering Price (1)(3)(4)	Amount of Registration Fee
Debt Securities				
Preferred Shares of Beneficial Interest, par value $.01 per share				
Common Shares of Beneficial Interest, par value $.01 per share				
Depositary Shares				
Warrants				
Rights				
TOTAL			$500,000,000	$58,050

(1) The Registrant is hereby registering such indeterminate amount and number of each identified class of the identified securities as may be issued upon conversion, exchange, or exercise of any other securities that provide for such conversion, exchange or exercise.

(2) The proposed maximum initial offering price per unit will be determined, from time to time, by the registrant.

(3) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(o) under the Securities Act of 1933, as amended. In no event will the aggregate initial offering price of all securities issued from time to time pursuant to this registration statement exceed $500,000,000.

(4) In U.S. dollars or the equivalent thereof in one or more foreign currencies or currency units or composite currencies, including the European Currency Unit.

The Registrant hereby amends this Registration Statement on the date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this

Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until this Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any jurisdiction where an offer or sale is not permitted.

Subject to Completion, dated June 9, 2011

PROSPECTUS

$500,000,000
RAMCO-GERSHENSON PROPERTIES TRUST
DEBT SECURITIES
PREFERRED SHARES
COMMON SHARES
DEPOSITARY SHARES
WARRANTS
RIGHTS

Ramco-Gershenson Properties Trust may offer, issue and sell from time to time our debt securities, which may be in one or more class or series and may be senior debt securities or subordinated debt securities; our preferred shares, which we may issue in one or more class or series; our common shares; depositary shares, each representing a fractional interest in a preferred share of a particular class or series; warrants to purchase our preferred shares or common shares; rights to purchase our common shares; and any combination of these securities. The securities will have an aggregate initial offering price of up to $500,000,000. We may sell any combination of the securities described in this prospectus in one or more offerings. We may offer the securities separately or together, in separate classes or series and in amounts, at prices and on terms described in one or more supplements to this prospectus and other offering material.

This prospectus describes some of the general terms that may apply to these securities. We will provide the specific terms of these securities in supplements to this prospectus. We may describe the terms of these securities in a term sheet which will precede the prospectus supplement. You should read this prospectus and the accompanying prospectus supplement carefully before you make your investment decision.

This prospectus may not be used to sell securities unless accompanied by a prospectus supplement.

The securities may be offered through one or more underwriters, dealers and agents or directly to purchasers on a continuous or delayed basis. The prospectus supplement for each offering of securities will describe in detail the plan of distribution for that offering.

Our common shares are traded on the New York Stock Exchange (the NYSE) under the symbol RPT. On June 8, 2011, the closing sale price of our common shares as reported on the NYSE was $12.51 per share. Our principal executive offices are located at 31500 Northwestern Highway, Suite 300, Farmington Hills, Michigan 48334, and our telephone number is (248) 350-9900.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR DETERMINED WHETHER THIS PROSPECTUS IS TRUTHFUL OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The date of this prospectus is ____, 2011

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You should rely only on the information provided or incorporated by reference in this prospectus or any applicable prospectus supplement. We have not authorized anyone to provide you with different or additional information. We are not making an offer to sell these securities in any jurisdiction where the offer or sale of these securities is not permitted. You should not assume that the information appearing in this prospectus, any accompanying prospectus supplement or the documents incorporated by reference herein or therein is accurate as of any date other than their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

You should read carefully the entire prospectus, as well as the documents incorporated by reference in the prospectus, before making an investment decision.

ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement on Form S-3 that we filed with the Securities and Exchange Commission, or the SEC, using a shelf registration process. Under this shelf registration process, we may, from time to time, sell any combination of the securities described in this prospectus, in one or more offerings, up to a maximum aggregate offering price of $500,000,000.

This prospectus provides you with a general description of the securities offered by us, which is not meant to be a complete description of each security. Each time we sell securities, we will provide a prospectus supplement containing specific information about the terms of that offering, including the specific amounts, prices and terms of the securities offered. The prospectus supplement and any other offering material may also add to, update or change information contained in this prospectus or in documents we have incorporated by reference into this prospectus. To the extent inconsistent, information in or incorporated by reference in this prospectus is superseded by the information in the prospectus supplement and any other offering material related to such securities.

This prospectus and any applicable prospectus supplement does not constitute an offer to sell, or a solicitation of an offer to purchase, the securities offered by such documents in any jurisdiction to or from any person to whom or from whom it is unlawful to make such an offer or solicitation of an offer in such jurisdiction.

You should not assume that the information contained in this prospectus or any prospectus supplement is accurate as of any date other than the date on the front cover of such documents. Neither the delivery of this prospectus or any applicable prospectus supplement nor any distribution of securities pursuant to such documents shall, under any circumstances, create any implication that there has been no change in the information set forth in this prospectus or any applicable prospectus supplement or in our affairs since the date of this prospectus or any applicable prospectus supplement.

In this prospectus and any prospectus supplement hereto, unless the context suggests otherwise, references to the Company, we, RPT, us, our Company, and our mean Ramco-Gershenson Properties Trust.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and periodic reports, proxy statements and other information with the SEC. You may read and copy any of these documents at the SEC s Public Reference Room located at 100 F Street, N.E., Washington, D.C. 20549. Information regarding the operation of the Public Reference Room may be obtained by calling 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants that file electronically with the SEC. The address of the SEC s website is http://www.sec.gov. Our SEC filings also are available through the New York Stock Exchange, 20 Broad Street, New York, New York 10005.

We have filed a registration statement on Form S-3 with the SEC covering the securities that may be sold under this prospectus. For further information on us and the securities being offered, you should refer to our registration statement and its exhibits. This prospectus summarizes material provisions of contracts and other documents that we refer you to. The rules and regulations of the SEC allow us to omit from this prospectus certain information that is included in the registration statement. Because the prospectus may not contain all the information that you may find important, you should review the full text of these documents. We have included, or incorporated by reference, copies of these documents as exhibits to our registration statement of which this prospectus is a part.

INCORPORATION OF INFORMATION WE FILE WITH THE SEC

The SEC allows us to incorporate by reference into this prospectus documents that we file with the SEC. This permits us to disclose important information to you by referring you to those filed documents. Any information incorporated by reference this way is considered to be a part of this prospectus, and information filed by us with the SEC subsequent to the date of this prospectus will automatically be deemed to update and supersede this information.

We incorporate by reference into this prospectus the documents listed below, which we have already filed with the SEC:

our Annual Report on Form 10-K for the year ended December 31, 2010;

the following sections from our Proxy Statement on Form DEF14A for our 2011 annual meeting of shareholders held on June 1, 2011: Trustees Background and Qualifications , The Board of Trustees , Committees of the Board , Trustee Compensation , Corporate Governance , Compensation Discussion and Analysis , Compensation Committee Report , Report of the Audit Committee , and Section 16(a) Beneficial Ownership Reporting Compliance ;

our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011;

our Current Reports on Form 8-K filed on April 5, 2011, April 6, 2011, April 12, 2011, April 28, 2011, April 29, 2011, May 2, 2011, May 5, 2011 and June 2, 2011; and

the description of our common shares contained in our registration statement on Form 8-A filed with the SEC on November 1, 1988 (which incorporates by reference pages 101-119 of our prospectus/proxy statement filed with the SEC on November 1, 1988), as updated by the description of our common shares contained in our definitive proxy statement on Schedule 14A for our special meeting of shareholders held on December 18, 1997.

Whenever, after the date of this prospectus, we file reports or documents under Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), those reports and documents will be incorporated by reference and deemed to be a part of this prospectus from the time they are filed (other than Current Reports or portions thereof furnished under Item 2.02 or Item 7.01 of Form 8-K). Any statement made in this prospectus or in a document incorporated or deemed to be incorporated by reference into this prospectus will be deemed to be modified or superseded for purposes of this prospectus to the extent that a statement contained in this prospectus or in any other subsequently filed document that is also incorporated or deemed to be incorporated by reference into this prospectus modifies or supersedes that statement. Any statement so modified or superseded will not be deemed, except as so modified or superseded, to constitute a part of this prospectus.

We will provide without charge, upon written or oral request, a copy of any or all of the documents which are incorporated by reference into this prospectus, excluding any exhibits to those documents unless the exhibit is specifically incorporated by reference as an exhibit to the registration statement of which this prospectus forms a part. Requests for documents should be directed to Ramco-Gershenson Properties Trust, 31500 Northwestern Highway, Suite 300, Farmington Hills, Michigan 48334 (telephone number (248) 350-9900).

You should rely only on the information contained or incorporated by reference into this prospectus and any applicable prospectus supplement. We have not authorized anyone to provide you with different or additional information. If anyone provides you with different or inconsistent information, you should not rely on it.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus and the information incorporated by reference contain certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Exchange Act. Statements that do not relate strictly to historical or current facts are forward-looking and are generally identifiable by use of forward-looking terminology such as may, will, should, potential, intend, expect, ende seek, anticipate, estimate, overestimate, underestimate, believe, could, project, predict, continue, pipeline, comfortable, current, position, assume, outlook, remain, maintain, sustain, achieve, wo words or expressions. Such statements are based on assumptions and expectations which may not be realized and are inherently subject to risks and uncertainties, many of which cannot be predicted with accuracy and some of which might not even be anticipated.

Forward-looking statements speak only as of the date they are made, and we assume no duty to and do not undertake to update forward-looking statements. Our future events, financial condition, business or other results may differ materially from those anticipated and discussed in the forward-looking statements. Risks and other factors that might cause differences, some of which could be material, include, but are not limited to, changes in political, economic or market conditions generally and the real estate and capital markets specifically; availability of capital; tenant bankruptcies; concentration of our credit risk; REIT distribution requirements; inability to successfully identify or complete suitable acquisitions and new developments; inability of our redevelopment projects to yield anticipated returns; competition for both the acquisition and development of real estate properties and the leasing operations; existing exclusivity lease provisions; lack of complete control and conflicts of interests in our joint ventures; potential bankruptcy of our joint venture partners; rising operating expenses; illiquidity of our real estate investments; potential losses that are not covered by insurance; our debt obligations; our financial covenants may restrict our operating or acquisition activities; mortgage debt obligations; a failure to qualify as a REIT; potential tax obligations; legislative or other actions affecting REITs; environmental laws and obligations; changes in generally accepted accounting principles or interpretations thereof; terrorist activities and international hostilities, which may adversely affect the general economy, domestic and global financial and capital markets, specific industries and us; the unfavorable resolution of legal proceedings; the impact of future acquisitions and divestitures; significant costs related to environmental issues as well as other risks listed from time to time in the Company s other reports and statements filed with the SEC.

When considering forward-looking statements, you should keep in mind the risk factors and other cautionary statements in this prospectus and any prospectus supplement hereto and in reports of the Company filed with the SEC. Readers are cautioned not to place undue reliance on any of these forward-looking statements, which reflect our management s views as of the date of this prospectus, or, if applicable, the date of a document incorporated by reference. All subsequent written and oral forward-looking statements attributable to us are expressly qualified in their entirety by the cautionary statements contained or referenced to in this section. Although we believe that the expectations reflected in the forward-looking statements are based on reasonable assumptions, we cannot guarantee future results, levels of activity, performance or achievements. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or the occurrence of unanticipated events except as required by applicable law.

WHO WE ARE

Ramco-Gershenson Properties Trust is a fully integrated, self-administered, publicly-traded Maryland real estate investment trust organized on October 2, 1997. The terms Company, we, our or us refer to Ramco-Gershenson Properties Trust, the Operating Partnership (defined below) and/or its subsidiaries, as the context may require. Our principal office is located at 31500 Northwestern Highway, Suite 300, Farmington Hills, Michigan 48334. Our predecessor, RPS Realty Trust, a Massachusetts business trust, was formed on June 21, 1988 to be a diversified growth-oriented REIT. In May 1996, RPS Realty Trust acquired the Ramco-Gershenson interests through a reverse merger, including substantially all of the shopping centers and retail properties as well as the management company and business operations of Ramco-Gershenson, Inc. and certain of its affiliates. The resulting trust changed its name to Ramco-Gershenson Properties Trust and Ramco-Gershenson, Inc. s officers assumed management responsibility. The trust also changed its operations from a mortgage real estate investment trust (REIT) to an equity REIT and contributed certain mortgage loans and real estate properties to Atlantic Realty Trust, an independent, newly formed liquidating REIT. In 1997, with approval from our shareholders, we changed our state of organization by terminating the Massachusetts trust and merging into a newly formed Maryland real estate investment trust.

We conduct substantially all of our business, and hold substantially all of our interests in our properties, through our operating partnership, Ramco-Gershenson Properties, L.P. (the Operating Partnership). The Operating Partnership, either directly or indirectly through partnerships or limited liability companies, holds fee title to all owned properties. We have the exclusive power to manage and conduct the business of the Operating Partnership. As of March 31, 2011, we owned approximately 93.1% of the interests in the Operating Partnership.

We are a REIT under the Internal Revenue Code of 1986, as amended (the Code), and are therefore required to satisfy various provisions under the Code and related Treasury regulations. We are generally required to distribute annually at least 90% of our REIT taxable income (as defined in the Code), excluding any net capital gain, to our shareholders. Additionally, at the end of each fiscal quarter, at least 75% of the value of our total assets must consist of real estate assets (including interests in mortgages on real property and interests in other REITs) as well as cash, cash equivalents and government securities. We are also subject to limits on the amount of certain types of securities we can hold. Furthermore, at least 75% of our gross income for the tax year must be derived from certain sources, which include rents from real property and interest on loans secured by mortgages on real property. An additional 20% of our gross income must be derived from these same sources or from dividends and interest from any source, gains from the sale or other disposition of stock or securities or any combination of the foregoing.

Certain of our operations, including property management and asset management, are conducted through taxable REIT subsidiaries (each, a TRS). A TRS is a C corporation that has not elected REIT status and, as such, is subject to federal corporate income tax. We use the TRS format to facilitate our ability to provide certain services and conduct certain activities that are not generally considered as qualifying REIT activities. Our executive offices are located at 31500 Northwestern Highway, Suite 300, Farmington Hills, Michigan 48334 (telephone number (248) 350-9900).

RISK FACTORS

Before you invest in any of our securities, in addition to the other information included or incorporated by reference into this prospectus and any applicable prospectus supplement, you should carefully consider the risk factors under the section entitled Risk Factors in any prospectus supplement as well as our most recent Annual Report on Form 10-K and in our Quarterly Reports on Form 10-Q filed subsequent to the Annual Report on Form 10-K, which are incorporated by reference into this prospectus and any prospectus supplement in their entirety, as the same may be amended, supplemented or superseded from time to time by other reports we file with the SEC in the future. In addition, new risks may emerge at any time and we cannot predict such risks or estimate the extent to which they may affect our business, financial condition, results of operations and prospects. For more information, see the sections entitled, Where You Can Find More Information and Incorporation of Information We File With the SEC in this prospectus.

USE OF PROCEEDS

Unless otherwise set forth in a prospectus supplement, we intend to use the net proceeds from the sale of the securities for working capital and other general corporate purposes, which may include repaying debt, financing capital commitments, and financing future acquisitions, redevelopment and development activities. We will have significant discretion in the use of any net proceeds. We may provide additional information on the use of the net proceeds from the sale of our securities in an applicable prospectus supplement or other offering materials relating to the offered securities.

RATIOS OF EARNINGS TO FIXED CHARGES AND PREFERRED SHARES DIVIDENDS

Ratio of Earnings to Combined Fixed Charges

The following table sets forth the historical ratios of earnings to fixed charges for the periods indicated:

		Years ended December 31,		
2010	**2009**	**2008**	**2007**	**2006**
(a)	1.39	1.88	1.98	1.80

Three months ended, March 31, 2011
(b)

(a) Due to a pretax loss from continuing operations for year ended December 31, 2010, the ratio coverage was less than 1:1. We would have needed to generate additional earnings of $19.6 million to achieve a coverage of 1:1 for 2010.

(b) Due to a pretax loss from continuing operations for the three months ended March 31, 2011, the ratio coverage was less than 1:1. We would have needed to generate additional earnings of $240,000 to achieve a coverage of 1:1 for the three months ended March 31, 2011.

For purposes of computing the ratio of earnings to combined fixed charges, earnings have been calculated by adding fixed charges (excluding capitalized interest and preferred share dividends) to income adjusted to remove noncontrolling interest in unconsolidated entities and income or loss from equity investees. Fixed charges consist of interest costs, whether expensed or capitalized, the interest component of rental expense, and amortization of deferred financing costs (including amounts capitalized) paid or accrued for the respective period.

The ratios are based solely on historical financial information, and no pro forma adjustment has been made thereto.

Ratio of Earnings to Combined Fixed Charges and Preferred Share Dividends

The following table sets forth the historical ratios of earnings to combined fixed charges and preferred share dividends for the periods indicated:

		Years ended December 31,		
2010	**2009**	**2008**	**2007**	**2006**
(a)	1.39	1.88	1.85	1.57

Three months ended, March 31, 2011
(b)

(a) Due to a pretax loss from continuing operations for year ended December 31, 2010, the ratio coverage were less than 1:1. We would have needed to generate additional earnings of $19.6 million to achieve a coverage of 1:1 for 2010.

(b)

Due to a pretax loss from continuing operations for the three months ended March 31, 2011, the ratio coverage was less than 1:1. We would have needed to generate additional earnings of $240,000 to achieve a coverage of 1:1 for the three months ended March 31, 2011.

For purposes of computing the ratio of earnings to combined fixed charges and preferred share dividends, earnings have been calculated by adding fixed charges (excluding capitalized interest and preferred share dividends) to income adjusted to remove noncontrolling interest in unconsolidated entities and income or loss from equity investees. Fixed charges consist of interest costs, whether expensed or capitalized, the interest component of rental expense, amortization of deferred financing costs (including amounts capitalized) and preferred dividends paid or accrued for the respective period.

The ratios are based solely on historical financial information, and no pro forma adjustment has been made thereto.

THE SECURITIES WE MAY OFFER

We may sell from time to time, in one or more offerings, common shares of beneficial interest, preferred shares of beneficial interest, debt securities, depositary shares, rights and/or warrants in a dollar amount that does not exceed $500,000,000. This prospectus contains only a summary of the securities we may offer. The specific terms of any securities actually offered for sale, together with the terms of that offering, the initial price and the net proceeds to us from the sale of such securities, will be set forth in an accompanying prospectus supplement. That prospectus supplement also will contain information, if applicable, about material United States federal income tax considerations relating to the securities and the securities exchange, if any, on which the securities will be listed. This prospectus may not be used to consummate a sale of securities unless it is accompanied by a prospectus supplement.

The following description of our common shares and preferred shares, together with the additional information we include in any applicable prospectus supplements, summarizes the material terms and provisions of the common shares and preferred shares that we may offer under this prospectus. For the complete terms of our common shares and preferred shares, please refer to our declaration of trust, as restated, amended and supplemented (the Declaration of Trust), as incorporated by reference into the registration statement which includes this prospectus. Maryland law will also affect the terms of these securities and the rights of holders thereof. While the terms we have summarized below will apply generally to any future common shares or preferred shares that we may offer, we will describe the particular terms of any class or series of these securities in more detail in the applicable prospectus supplement. If we so indicate in any applicable prospectus supplement, the terms of any common shares or preferred shares we offer may differ from the terms we describe below.

Our authorized shares consist of an aggregate of 70,000,000 shares of beneficial interest, par value $0.01 per share, consisting of 60,000,000 common shares and 10,000,000 preferred shares which may be issued in one or more classes or series, each with such terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption, as are permitted by Maryland law and as our board of trustees may determine by resolution. As of May 4, 2011, we had issued and outstanding 38,521,589 common shares and 2,000,000 7.25% Series D Cumulative Convertible Perpetual Preferred Shares of Beneficial Interest (Series D preferred shares).

DESCRIPTION OF DEBT SECURITIES

We may issue debt securities either separately, or together with, or upon the conversion of or in exchange for, other securities. The debt securities may be our unsecured and unsubordinated obligations or our subordinated obligations. We use the term senior debt securities to refer to the unsecured and unsubordinated obligations. We use the term subordinated debt securities to refer to the subordinated obligations. The subordinated debt securities of any class or series may be our senior subordinated obligations, subordinated obligations, junior subordinated obligations or may have such other ranking as is described in the relevant prospectus supplement. We may issue any of these types of debt securities in one or more classes or series.

Our senior debt securities may be issued from time to time under a senior debt securities indenture with a trustee to be named in the senior debt securities indenture. Our subordinated debt securities may be issued from time to time under a subordinated debt securities indenture with a trustee to be named in the subordinated debt securities indenture, which will describe the specific terms of the debt class or series. We use the term indenture to refer to the senior debt securities indenture or the subordinated debt securities indenture. We use the term trustee to refer to the trustee named in the senior debt securities indenture or the subordinated debt securities indenture.

Some of our operations are conducted through our subsidiaries. Accordingly, our cash flow and our ability to service our debt, including the debt securities, are dependent upon the earnings of our subsidiaries and the distribution of those earnings to us, whether by dividends, loans or otherwise. The payment of dividends and the making of loans and advances to us by our subsidiaries may be (i) subject to statutory or contractual restrictions, (ii) contingent upon the earnings of our subsidiaries, and (iii) subject to various business considerations. Our right to receive assets of any of our subsidiaries upon their liquidation or reorganization (and the consequent right of the holders of the debt securities to participate in those assets) will be effectively subordinated to the claims of that subsidiary s creditors (including trade creditors), except to the extent that we are recognized as a creditor of that subsidiary, in which case our claims would still be subordinate to any security interests in the assets of the subsidiary and any indebtedness held by a subsidiary that is senior to indebtedness held by us.

The following summary of selected provisions that will be included in indentures and in the debt securities is not complete. Before making an investment in our debt securities, you should review the applicable prospectus supplement and the form of applicable indenture, which will be filed with the SEC in connection with the offering of the specific debt securities.

General

We can issue debt securities of any class or series with terms different from the terms of debt securities of any other class or series and the terms of particular debt securities within any class or series may differ from each other, all without the consent of the holders of previously issued classes or series of debt securities. The debt securities of each class or series will be our direct, unsecured obligations.

The applicable prospectus supplement relating to the class or series of debt securities will describe the specific terms of each class or series of debt securities being offered, including, where applicable, the following:

- the title;
- the aggregate principal amount and whether there is any limit on the aggregate principal amount that we may subsequently issue;
- whether the debt securities will be senior, senior subordinated, subordinated or junior subordinated;
- the name of the trustee and its corporate trust office;
- any limit on the amount of debt securities that may be issued;
- any subordination provisions;
- any provisions regarding the conversion or exchange of such debt securities with or into other securities;
- any default provisions and events of default applicable to such debt securities;
- any covenants applicable to such debt securities;
- whether such debt securities are issued in certificated or book-entry form, and the identity of the depositary for those issued in book-entry form;
- whether such debt securities are to be issuable in registered or bearer form, or both, and any restrictions applicable to the exchange of one form or another and to the offer, sale and delivery of such debt securities in either form;
- whether such debt securities may be represented initially by a debt security in temporary or permanent global form, and, if so, the initial depositary and the circumstances under which beneficial owners of interests may exchange such interests for debt securities of like tenor and of any authorized form and denomination and the authorized newspapers for publication of notices to holders of bearer securities;
- any other terms required to establish a class or series of bearer securities;
- the price(s) at which such debt securities class or series will be issued;
- the person to whom any interest will be payable on any debt securities, if other than the person in whose name the debt security is registered at the close of business on the regular record date for the payment of interest;

any provisions restricting the declaration of dividends or requiring the maintenance of any asset ratio or maintenance of reserves;

the date or dates on which the principal of and premium, if any, is payable or the method(s), if any, used to determine those dates;

the rate(s) at which such debt securities will bear interest or the method(s), if any, used to calculate the rate(s);

the date(s), if any, from which any interest will accrue, or the method(s), if any, used to determine the dates on which interest will accrue and date(s) on which interest will be payable;

any redemption or early repayment provisions applicable to such debt securities;

the stated maturities of installments of interest, if any, on which any interest on such debt securities will be payable and the regular record dates for any interest payable on any debt securities which are registered securities;

the places where and the manner in which the principal of and premium and/or interest, if any, will be payable and the places where the debt securities may be presented for transfer;

our obligation or right, if any, to redeem, purchase or repay such debt securities of the class or series pursuant to any sinking fund amortization or analogous provisions or at the option of a holder of such debt securities and other related provisions;

the denominations in which any registered securities are to be issuable;

the currency, currencies or currency units, including composite currencies, in which the purchase price for, the principal of and any premium and interest, if any, on such debt securities will be payable;

the time period within which, the manner in which, and the terms and conditions upon which, the purchaser of any of such debt securities can select the payment currency;

if the amount of payments of principal, premium, if any, and interest, if any, on such debt securities is to be determined by reference to an index, formula or other method, or based on a coin or currency or currency unit other than that in which such debt securities are stated to be payable, the manner in which these amounts are to be determined and the calculation agent, if any, with respect thereto;

if other than the principal amount thereof, the portion of the principal amount of the debt securities of the class or series which will be payable upon declaration or acceleration of the maturity thereof pursuant to an event of default;

if we agree to pay any additional amounts on any of the debt securities, and coupons, if any, of the classes or series to any holder in respect of any tax, assessment or governmental charge withheld or deducted, the circumstances, procedures and terms under which we will make these payments;

any terms applicable to debt securities of any class or series issued at an issue price below their stated principal amount;

whether such debt securities are to be issued or delivered (whether at the time of original issuance or at the time of exchange of a temporary security of such class or series or otherwise), or any installment of principal or any premium or interest is to be payable only, upon receipt of certificates or other documents or satisfaction of other conditions in addition to those specified in the applicable indenture;

any provisions relating to covenant defeasance and legal defeasance;

any provisions relating to the satisfaction and discharge of the applicable indenture;

any special applicable United States federal income tax considerations;

any provisions relating to the modification of the applicable indenture both with and without the consent of the holders of the debt securities of the class or series issued under such indenture; and

any other material terms not inconsistent with the provisions of the applicable indenture.

The above is not intended to be an exclusive list of the terms that may be applicable to any debt securities and we are not limited in any respect in our ability to issue debt securities with terms different from or in addition to those described above or elsewhere in this prospectus, provided that the terms are not inconsistent with the applicable indenture. Any applicable prospectus supplement will also describe any special provisions for the payment of additional amounts with respect to the debt securities. United States federal income tax consequences and special considerations, if any, applicable to any such class or series will be described in the applicable prospectus supplement.

Debt securities may be issued where the amount of principal and/or interest payable is determined by reference to one or more currency exchange rates, commodity prices, equity indices or other factors. Holders of such securities may receive a principal amount or a payment of interest that is greater than or less than the amount of principal or interest otherwise payable on such dates, depending upon the value of the applicable currencies, commodities, equity indices or other factors. Information as to the methods for determining the amount of principal or interest, if any, payable on any date, the currencies, commodities, equity indices or other factors to which the amount payable on such date is linked and certain additional United States federal income tax considerations will be set forth in the applicable prospectus supplement.

Subject to the limitations provided in the indenture and in the prospectus supplement, debt securities that are issued in registered form may be transferred or exchanged at the corporate office of the trustee maintained in the City of New York or the principal corporate trust office of the trustee, without the payment of any service charge, other than any tax or other governmental charge payable in connection therewith.

Global Securities

The debt securities of a class or series may be issued in whole or in part in the form of one or more global securities that will be deposited with, or on behalf of, a depositary identified in the prospectus supplement. Global securities will be issued in registered form and in either temporary or definitive form. Unless and until it is exchanged in whole or in part for the individual debt securities, a global security may not be transferred except as a whole by the depositary for such global security to a nominee of such depositary or by a nominee of such depositary to such depositary or another nominee of such depositary or by such depositary or any such nominee to a successor of such depositary or a nominee of such successor. The specific terms of the depositary arrangement with respect to any debt securities of a class or series and the rights of and limitations upon owners of beneficial interests in a global security will be described in the applicable prospectus supplement.

DESCRIPTION OF COMMON SHARES

This section describes the general terms and provisions of our common shares of beneficial interest, par value $.01 per share. This summary is not complete. We have incorporated by reference our Declaration of Trust and our bylaws, as amended and restated (our Bylaws) as exhibits to the registration statement of which this prospectus is a part. We have also incorporated by reference in this prospectus a description of our common shares which is contained in other documents we have filed with the SEC. You should read these other documents before you acquire any common shares.

Common Shares

Certain rights that accompany the ownership of our common shares may be subject to the preferential rights of other classes or series of our shares and to the provisions of our Declaration of Trust regarding restrictions on transfer of our shares.

General

As of May 4, 2011 our authorized capital included 60,000,000 common shares, of which 38,521,589 shares were issued and outstanding. All common shares offered pursuant to any prospectus supplement will, when issued, be duly authorized, fully paid and non-assessable. This means that the full price for our common shares will be paid at issuance and that you, as a purchaser of such common shares will not be later required to pay us any additional monies for such common shares.

Dividends

Subject to the preferential rights of any shares or class or series of beneficial interest that we may issue in the future, and to the provisions of the Declaration of Trust regarding the restriction on transfer and ownership of common shares, holders of common shares are entitled to receive dividends on such shares out of our funds that we can legally use to pay dividends, when, as and if such dividends are declared by our board of trustees.

Voting Rights

Subject to the provisions of our Declaration of Trust regarding restrictions on the transfer and ownership of shares of beneficial interest, the holders of common shares have the exclusive power to vote on all matters presented to our shareholders unless the terms of any outstanding preferred shares give the holders of preferred shares the right to vote on certain matters or generally. Each outstanding common share entitles the holder to one vote on all matters submitted to a vote of shareholders, including the election of trustees. There is no cumulative voting in the election of our trustees, which means that the holders of a majority of the outstanding common shares can elect all of the trustees then standing for election, and the votes held by the holders of the remaining common shares, if any, will not be sufficient to elect any trustee.

Other Rights

Subject to the provisions of our Declaration of Trust regarding restrictions on the transfer and ownership of shares of beneficial interest, each common share has equal distribution, liquidation and other rights, and has no preference, conversion, sinking fund, redemption or preemptive rights.

Pursuant to our Declaration of Trust and Maryland law, most mergers, any consolidation or sale of all or substantially all of our assets or dissolution require the affirmative vote of at least two-thirds of all the votes entitled to be cast by our shareholders on the matter. Any amendment to our Declaration of Trust, other than an amendment of any of the sections of our Declaration of Trust which provide that the matters described in the foregoing sentence must be approved by a two-thirds vote, requires the affirmative vote of at least a majority of all the votes entitled to be cast by our shareholders on the matter. Subject to any rights of holders of one or more classes or series of our preferred shares to elect one or more trustees, at a meeting of our shareholders, the affirmative vote of at least two-thirds of our shareholders entitled to vote generally in the election of trustees is required in order to remove a trustee. Our Declaration of Trust authorizes our board of trustees to increase or decrease the aggregate number of our authorized shares of beneficial interest and the number of shares of any class or series of beneficial interest without shareholder approval.

Transfer Agent and Registrar

The transfer agent and registrar for our common shares is the American Stock Transfer & Trust Company.

Power To Reclassify Our Shares

Our Declaration of Trust authorizes our board of trustees to classify and reclassify any of our unissued common shares and preferred shares into other classes or series of shares. Prior to issuance of shares of each class or series, our board of trustees is required by Maryland law and by our Declaration of Trust to set, subject to the restrictions on transfer and ownership of shares contained in our Declaration of Trust, the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each class or series. Thus, our board of trustees could authorize the issuance of preferred shares with terms and conditions which could have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for holders of our common shares or otherwise be in their best interest.

Power To Increase Our Authorized Capital and to Issue Additional Common Shares And Preferred Shares

Our Declaration of Trust authorizes our board of trustees, without the approval of our shareholders, to amend our Declaration of Trust from time to time to increase or decrease the aggregate number of common shares and/or preferred shares or the number of shares of any class or series that we have authority to issue.

We believe that the power to increase our authorized capital, to issue additional common shares or preferred shares and to classify or reclassify unissued common or preferred shares and thereafter to issue the classified or reclassified shares provides us with increased flexibility in structuring possible future financings and acquisitions and in meeting other needs which might arise. These actions can be taken without shareholder approval, unless shareholder approval is required by applicable law or the rules of any stock exchange or automated quotation system on which our securities may be listed or traded.

The description of the limitations on the liability of shareholders of ours set forth under Description of Preferred Shares is applicable to holders of common shares.

Restrictions On Ownership And Transfer

In order for us to qualify as a REIT, we must not be closely held as determined under Section 856(h) of the Code. We will not be considered closely held if no more than 50% in value of our outstanding shares is actually or constructively owned by five or fewer individuals (as determined by applying certain attribution rules under the Code) during the last half of a taxable year (other than the first year for which an election to be treated as a REIT has been made) or during a proportionate part of a shorter taxable year. In addition, in order for us to qualify as a REIT, we must satisfy two gross income tests that require us to derive a certain percentage of our income from certain qualifying sources, including rents from real property. If we, or an owner of 10% or more of our shares, actually or constructively owns 10% or more of one of our tenants (or a tenant of any partnership in which we are a partner), the rent we receive (either directly or through any such partnership) from such tenant (referred to in this section as a Related Party Tenant) will not be treated as qualifying rent for purposes of the REIT gross income tests. Moreover, in order for us to qualify as a REIT, at least 100 persons must beneficially own our shares during 335 or more days of a taxable year of twelve months or during a proportionate part of a shorter taxable year (other than the first year for which we elected to be treated as a REIT).

In order to assist us in preserving our REIT status, our Declaration of Trust prohibits:

any person from actually or constructively owning our shares that would cause us to be closely held under Section 856(h) of the Code or otherwise cause us to fail to qualify as a REIT, including by reason of receiving rents from tenants that are Related Party Tenants in an amount that would cause us to fail to satisfy one or both of the REIT gross income tests, and

any person from transferring our shares if the transfer would cause our shares to be owned by fewer than 100 persons.

In addition, to assist us in avoiding a transfer of shares that would cause us to become closely held or the receipt of rent from a Related Party Tenant, our Declaration of Trust, subject to customary exceptions, provides that no holder may actually or constructively own more than the ownership limit as determined by applying certain attribution rules under the Code. The ownership limit means:

with respect to our common shares, 9.8%, in value or number of shares, whichever is more restrictive, of our outstanding common shares, and

with respect to any class or series of our preferred shares, 9.8%, in value or number of shares, whichever is more restrictive, of the outstanding shares of the applicable class or series of our preferred shares.

The attribution rules under the Code are complex and may cause common shares actually or constructively owned by a group of related individuals and/or entities to be treated as being constructively owned by one individual or entity. As a result, the acquisition by an individual or entity of less than 9.8% of our common shares (or the acquisition by an individual or entity of an interest in an entity that actually or constructively owns our common shares) could cause such individual or entity, or another individual or entity, to constructively own in excess of 9.8% of our outstanding common shares and, thus, subject those common shares to the ownership limit.

Our Declaration of Trust provides that our board of trustees may, in its sole discretion and upon the vote of 75% of its members, grant an exemption from the ownership limit with respect to a person (or more than one person) who would not be treated as an individual for purposes of the Code if such person submits to the board information satisfactory to the board, in its reasonable discretion, demonstrating that:

such person is not an individual for purposes of the Code,

such person s share ownership will not cause a person who is an individual to be treated as owning common shares in excess of the ownership limit, applying the attribution rules under the Code, and

such person s share ownership will not otherwise jeopardize our REIT status.

As a condition of a waiver, our board of trustees may, in its reasonable discretion, require undertakings or representations from such person to ensure that the conditions described above are satisfied and will continue to be satisfied for as long as such person owns shares in excess of the ownership limit.

Our Declaration of Trust provides that, under some circumstances, our board of trustees may, in its sole discretion and upon the vote of 75% of its members, grant an exemption for individuals to acquire preferred shares in excess of the ownership limit.

Our Declaration of Trust provides that our board of trustees also has the authority to increase the ownership limit from time to time, but it does not have the authority to do so to the extent that, after giving effect to an increase, five beneficial owners of our common shares could beneficially own in the aggregate more than 49.5% of the value of our outstanding common shares.

Any person who acquires, or attempts or intends to acquire, actual or constructive ownership of our shares that violates or may violate any of the foregoing restrictions on transferability and ownership will be required to give notice to us immediately and provide us with any information that we may request in order to determine the effect of the transfer on our REIT status.

If any purported transfer of our shares or any other event would otherwise result in any person violating the ownership limit or the other restrictions in our Declaration of Trust, then our Declaration of Trust provides that the purported transfer will be void and of no force or effect with respect to the purported transferee as to that number of shares that exceeds the ownership limit and the purported transferee will acquire no right or interest (or, in the case of any event other than a purported transfer, the person or entity holding record title to any shares in excess of the ownership limit will cease to own any right or interest) in those excess shares. Our Declaration of Trust provides that any excess shares described above will be transferred automatically, by operation of law, to a trust, the beneficiary of which will be a qualified charitable organization selected by us. This automatic transfer will be deemed to be effective as of the close of business on the business day (as defined in our Declaration of Trust) prior to the date of the violating transfer.

Within 20 days of receiving notice from us of the transfer of shares to the trust, our Declaration of Trust provides that the trustee of the trust (who will be designated by us and will be unaffiliated to us and the purported transferee or owner) will be required to sell the excess shares to a person or entity who could own those shares without violating the ownership limit and distribute to the purported transferee an amount equal to the lesser of the price paid by the purported transferee for the excess shares or the sales proceeds received by the trust for the excess shares. In the case of any excess shares resulting from any event other than a transfer, or from a transfer for no consideration (such as a gift), our Declaration of Trust provides that the trustee will be required to sell the excess shares to a qualified person or entity and distribute to the purported owner an amount equal to the lesser of the fair market value of the excess shares as of the date of the event or the sales proceeds received by the trust for the excess shares. In either case, any proceeds in excess of the amount distributable to the purported transferee or owner, as applicable, will be distributed to the beneficiary of the trust.

Prior to a sale of any excess shares by the trust, our Declaration of Trust provides that the trustee will be entitled to receive, in trust for the beneficiary, all dividends and other distributions paid by us with respect to the excess shares, and also will be entitled to exercise all voting rights with respect to the excess shares. Subject to Maryland law, effective as of the date that the shares have been transferred to the trust, the trustee will have the authority (at the trustee s sole discretion and subject to applicable law) (1) to rescind as void any vote cast by a purported transferee prior to the discovery by us that its shares have been transferred to the trust and (2) to recast votes in accordance with the desires of the trustee acting for the benefit of the beneficiary of the trust. Our Declaration of Trust provides that any dividend or other distribution paid to the purported transferee or owner (prior to the discovery by us that its shares had been automatically transferred to a trust as described above) will be required to be repaid to the trustee upon demand for distribution to the beneficiary of the trust.

If the transfer to the trust as described above is not automatically effective (for any reason) to prevent violation of the ownership limit, then our Declaration of Trust provides that the transfer of the excess shares will be void.

In addition, our Declaration of Trust provides that our shares held in the trust will be deemed to have been offered for sale to us, or our designee, at a price per share equal to the lesser of (1) the price per share in the transaction that resulted in the transfer to the trust (or, in the case of a devise or gift, the fair market value at the time of that devise or gift) and (2) the fair market value of such shares on the date we, or our designee, accept the offer. We will have the right to accept the offer until the trustee has sold the shares of beneficial interest held in the trust. Upon the sale to us, our Declaration of Trust provides that the interest of the beneficiary in the shares sold will terminate and the trustee will distribute the net proceeds of the sale to the purported owner.

All certificates evidencing our shares will bear a legend referring to the restrictions described above and a statement that we will furnish a copy of our Declaration of Trust to a shareholder on request and without charge.

All persons who own, either actually or constructively by application of the attribution rules under the Code, more than 5% (or other percentage between 1/2 of 1% and 5% as provided in applicable rules and regulations under the Code) of the lesser of the number or value of our outstanding shares must give a written notice to us by January 30 of each year. In addition, each shareholder will, upon demand, be required to disclose to us in writing information with respect to the direct, indirect and constructive ownership of our shares that our board of trustees deems reasonably necessary to comply with the provisions of the Code applicable to a REIT, to comply with the requirements of any taxing authority or governmental agency or to determine our compliance with such provisions or requirements.

DESCRIPTION OF PREFERRED SHARES

The following description of the preferred shares, which may be offered pursuant to a prospectus supplement, sets forth certain general terms and provisions of the preferred shares to which any prospectus supplement may relate. The particular terms of the preferred shares being offered and the extent to which such general provisions may or may not apply will be described in a prospectus supplement relating to such preferred shares. The statements below describing the preferred shares are in all respects subject to and qualified in their entirety by reference to the applicable provisions of our Declaration of Trust (including any articles supplementary setting forth the terms of the preferred shares), and our Bylaws.

Subject to limitations prescribed by Maryland law and our Declaration of Trust, our board of trustees is authorized to fix the number of shares constituting each class or series of preferred shares and to set or fix the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption of each such class or series. The preferred shares will, when issued, be fully paid and nonassessable and will have no preemptive rights.

Pursuant to our Declaration of Trust, our board of trustees may authorize the issuance of up to 10,000,000 preferred shares of beneficial interest, par value $.01 per share, in one or more classes or series and may classify any unissued preferred shares and reclassify any previously classified but unissued preferred shares of any class or series.

We have classified and designated 2,000,000 authorized but unissued preferred shares as 7.25% Series D Cumulative Convertible Perpetual Preferred Shares of Beneficial Interest, par value $.01 per share, with a liquidation preference of $50.00 per share, which are referred to herein as the Series D preferred shares. As of May 5, 2011, 2,000,000 Series D preferred shares were issued and outstanding. We pay cumulative dividends on the Series D preferred shares, when, as and if declared by our board of trustrees, at a rate of 7.25% of the liquidation preference per annum. The annual dividend on each Series D preferred share is $3.625, payable quarterly in arrears on January 1, April 1, July 1 and October 1 of each year, as and if declared by our board of trustees. Holders of the Series D preferred shares generally have no voting rights except for limited voting rights if we fail to pay dividends for six or more quarterly periods (whether or not consecutive) and in certain other circumstances. The Series D preferred shares are convertible, at the holder s option, at any time and from time to time, subject to certain restrictions on ownership and transfer, into our common shares at an initial conversion rate of 3.4699 common shares per Series D preferred share, subject to adjustment. At any time on or after April 20, 2018, at our option and based on the market price of our common shares, we may be able to cause the Series D preferred shares to be automatically converted into a number of common shares for each Series D preferred share equal to the conversion rate then in effect.

The register and transfer agent for any preferred shares will be set forth in the applicable prospectus supplement.

Reference is made to the prospectus supplement relating to the preferred shares offered thereby for specific terms, including:

- the title and stated value of such preferred shares;
- the number of such preferred shares being offered, the liquidation preference per share and the offering price of such preferred shares;
- the distribution rate(s), period(s) and/or payment date(s) or method(s) of calculation thereof applicable to such preferred shares;
- the date from which distributions on such preferred shares shall accumulate, if applicable;

the procedures for any auction and remarketing, if any, for such preferred shares;

The August 1, 2007 final rule made further changes designed to continue to improve the accuracy of Medicare s payment under the acute care IPPS. The IPPS payment reforms are designed to restructure the inpatient diagnosis-related groups (DRGs) to account more fully for the severity of each patient s condition. In addition, the rule includes important provisions to ensure that Medicare no longer pays for the additional costs of certain preventable conditions (including certain infections) acquired in the hospital. The rule also reduces Medicare payments when a hospital replaces a device that is supplied to the hospital at no or reduced cost.

It is estimated that payments to all hospitals will increase by an average of 3.5 percent for the federal fiscal year beginning October 1, 2007 when all provisions of the rule are taken into account, primarily as a result of a 3.3 percent market basket increase. Payments to specific hospitals may increase more or less than this amount depending on the patients they serve. For instance, urban hospitals generally treat more severely ill patients and are estimated to receive a 3.8 percent increase in payments. The rule creates 745 new severity-adjusted DRGs to replace the current 538 DRGs. Projected aggregate spending will not change as a result of the reforms. However, payments will increase for hospitals serving more severely ill patients and decrease for those serving patients who are less severely ill.

The rule also implements a provision of the Deficit Reduction Act of 2005 (DRA) that takes the first steps toward preventing Medicare from giving hospitals higher payment for the additional costs of treating a patient who acquires a condition (including an infection) during a hospital stay. Already the feature of many state health care programs, the DRA requires hospitals to begin reporting secondary diagnoses that are present on the admission of patients, beginning with discharges on or after October 1, 2007. Beginning on October 1, 2008, cases with these conditions would not be paid at a higher rate unless they were present on admission. In order to improve the reliability of care in the nation s hospitals, the rule identifies eight conditions, including three serious preventable events (sometimes called never events) that meet the statutory criteria. CMS is expected to add an additional 3 conditions to the list in 2008 to become effective in Federal Fiscal beginning October 1, 2008.

Prior to July 1, 2005, long-term care psychiatric units within hospitals were exempt from the prospective payment system, and were reimbursed under the provisions of a cost-based system, subject to specific reimbursement caps. Beginning on July 1, 2005 and for three years thereafter these units have been or will be partially reimbursed based on a prospective payment system based on patient acuity with the remaining portion of the payment continuing to be reimbursed based on a cost based system. The transition period for the implementation of this new prospective system was 25% for the year ending June 30, 2006, and 50% in 2007 and will be 75% in 2008. Beginning on July 1, 2008 long-term care psychiatric units will be fully reimbursed based on the federal inpatient psychiatric prospective payment rate. SunLink operates one psychiatric unit in one of its hospitals and believes this change will have a minimal effect on SunLink s revenues.

Medicare Outpatient Reimbursement

Most outpatient services provided by general hospitals are reimbursed by Medicare under the outpatient prospective payment system. This outpatient prospective payment system is based on a system of Ambulatory Payment Classifications (APC). Each APC is designed to represent a bundle of outpatient services, and each APC is assigned a fully prospective reimbursement rate. Medicare pays a set price or rate for each APC group, regardless of the actual cost incurred in providing care. Each APC rate generally is subject to adjustment each year by an update factor based on a market basket of services index. For calendar years 2003, 2004, 2005, 2006, and 2007 the update factor was 3.7%, 4.5%, 3.3%, 3.7%, and 3.4%, respectively. If the update factor does not adequately reflect increases in SunLink s cost of providing outpatient services, our financial condition or results of operations could be negatively affected.

Medicare Disproportionate Share Payments

In addition to the standard DRG payment, the Social Security Act requires that additional Medicare payments be made to hospitals with a disproportionate share of low income patients. BIPA provisions, effective for services provided on and after April 1, 2001, stipulate that rural facilities with fewer than 100 beds with a disproportionate share percentage greater than 15% will be classified as a disproportionate share hospital entitled to receive a supplemental disproportionate share payment based on gross DRG payments. For discharges between October 1, 2002 through March 31, 2004, the disproportionate share payment was 5.25% and since April 1, 2004, the effective rate has been 12.0% of DRG payments. All of our hospitals were classified as disproportionate share hospitals at June 30, 2007. We estimate that Medicare disproportionate share payments represented approximately 1% of our net patient service revenues for the years ended June 30, 2005, 2006 and 2007.

Medicaid

Each state operates a Medicaid program funded jointly by the state and the Federal government. Federal law governs the general management of the Medicaid program, but there is wide latitude for states to customize Medicaid programs to fit local needs and resources. As a result, each state Medicaid plan has its own payment formula and recipient eligibility criteria.

In the recent past the various states in which Sunlink operates hospitals initiated increased efforts to reduce Medicaid assistance payments. These efforts and reductions have been triggered by an increased effort by CMS to decrease the federal share of payments for Medicaid beneficiaries as well as by the significant increases in program utilization resulting from increased enrollment and from budgetary cuts facing states where Sunlink operates. In particular, Georgia, where SunLink operates three hospitals, has begun initiatives to decrease the Medicaid funds paid to providers.

Georgia Historically, the state of Georgia has reimbursed Medicaid providers for inpatient services in a manner similar to the Medicare prospective payment system in that hospitals received a fixed fee for inpatient hospital services based on the established fixed payment amount per discharge for categories of hospital treatment, known as DRGs. These Medicaid DRG payments do not consider a specific hospital s costs, but are statewide rates adjusted for each hospitals capital cost allotment. Medicaid outpatient services are reimbursed with interim rates based on a facility specific cost to charge ratio. These interim payments are then adjusted subsequent to the end of the cost reporting period to an amount equal to 85.6% of the costs associated with providing care to the Medicaid outpatient population. Beginning in Georgia s fiscal year ended June 30, 2006, Georgia implemented a Medicaid HMO program and awarded contracts to private companies for the management and processing of certain Medicaid claims. The intent of the Medicaid HMO program is to curtail utilization and save the state of Georgia an anticipated $60,000 in the fiscal year ended June 30, 2006 and $200,000 annually thereafter. The effect of implementing a state-wide HMO program is intended to reduce rates paid by the State of Georgia. All of Sunlink s facilities that operate in the state of Georgia have signed contracts with all the HMO companies contracted by the state.

Government Reimbursement Program Administration and Adjustments

The Medicare, Medicaid and TriCare programs are subject to statutory and regulatory changes, administrative rulings, interpretations and determinations, requirements for utilization review and new governmental funding restrictions, all of which may materially increase or decrease program payments as well as affect the cost of providing services and the timing of payments to facilities.

All hospitals participating in the Medicare and Medicaid programs, whether paid on a reasonable cost basis or under a prospective payment system, are required to meet certain financial reporting requirements. Federal and, where applicable, state regulations require the submission of annual cost reports covering the revenue, costs and expenses associated with the services provided by each hospital to Medicare beneficiaries and Medicaid recipients.

Annual cost reports required under the Medicare and Medicaid programs are subject to routine audits which may result in adjustments to the amounts ultimately determined to be due to SunLink under these reimbursement programs. These audits often require several years to reach the final determination of amounts due. Providers also have rights of appeal and it is common to contest issues raised in audits of prior years cost reports. Although the final outcome of these audits and the nature and amounts of any adjustments are difficult to predict, we believe that we have made adequate provisions in our financial statements for adjustments that may result from these audits and that final resolution of any contested issues should not have a material adverse effect upon our consolidated results of operations or financial position. Until final adjustment, however, significant issues may remain unresolved and previously determined allowances could become either inadequate or greater than ultimately required.

If SunLink or any of our facilities were found to be in violation of Federal or state laws relating to Medicare, Medicaid or similar programs, SunLink could be subject to substantial monetary fines, civil penalties and exclusion from future participation in the Medicare and Medicaid programs. Any such sanctions could have a material adverse effect on our financial position and results of operations.

Healthcare Regulation

Overview

The healthcare industry is one of the largest industries in the United States and continues to attract much legislative interest and public attention. There are many factors that are highly significant to the healthcare industry including Medicare, Medicaid, and other public and private hospital cost-containment programs, proposals to limit healthcare spending and proposals to limit prices and industry competition factors. The healthcare industry is governed by an extremely complex framework of Federal, state and local laws, rules and regulations.

There continue to be Federal and state proposals that would, and actions that do, impose limitations on government and private payments to providers, including community hospitals. In addition, there regularly are proposals to increase co-payments and deductibles from program and private patients. Hospital facilities also are affected by controls imposed by government and private payors designed to reduce admissions and lengths of stay. Such controls, include what is commonly referred to as utilization review . Utilization review entails the review of a patient s admission and course of treatment by a third party. Historically, utilization review has resulted in a decrease in certain treatments and procedures being performed. Utilization review is required in connection with the provision of care which is to be funded by Medicare and Medicaid and is also required under many managed care arrangements.

Many states have enacted, or are considering enacting, additional measures that are designed to reduce their Medicaid expenditures and to make changes to private healthcare insurance. Various states have applied, or are considering applying, for a waiver from current Medicaid regulations in order to allow them to serve some of their Medicaid participants through managed care providers. These proposals also may attempt to include coverage for some people who presently are uninsured, and generally could have the effect of reducing payments to hospitals, physicians and other providers for the same level of service provided under Medicaid.

Certificate of Need Requirements

A number of states require approval for the purchase, construction and expansion of healthcare facilities, including findings of need for additional or expanded healthcare facilities or services. Certificates of need (CON), which are issued by governmental agencies with jurisdiction over healthcare facilities, are at times required for capital expenditures exceeding a prescribed amount, changes in bed capacity or the addition of services and certain other matters. All four states in which SunLink currently operates hospitals (Alabama, Georgia, Mississippi and Missouri) have CON laws. The states periodically review, modify and revise their CON laws and related regulations.

In addition, future hospital acquisitions may occur in states that require certificates of need. SunLink is unable to predict whether its hospitals will be able to obtain any certificates of need that may be necessary to accomplish their business objectives in any jurisdiction where such certificates of need are required. Violation of these state laws may result in the imposition of civil sanctions or the revocation of hospital licenses.

Future hospital acquisitions may occur in states that do not require certificates of need or which have less stringent CON requirements than the states in which SunLink currently operates hospitals. Any hospital operated by SunLink in such states may face increased competition from new or expanding facilities operated by competitors.

Fraud and Abuse, Anti-Kickback and Self-Referral Regulations

Participation in the Medicare and/or Medicaid programs is heavily regulated by federal statutes and regulations. If a hospital fails to comply substantially with the numerous federal laws governing a facility s activities, the hospital s participation in the Medicare and/or Medicaid programs may be terminated and/or civil or criminal penalties may be imposed. For example, a hospital may lose its ability to participate in the Medicare and/or Medicaid programs if it performs any of the following acts:

- making claims to Medicare and/or Medicaid for services not provided or misrepresenting actual services provided in order to obtain higher payments;
- paying money to induce the referral of patients or purchase of items or services where such items or services are reimbursable under a federal or state health program; or
- failing to provide appropriate emergency medical screening services to any individual who comes to a hospital s campus or otherwise failing to properly treat and transfer emergency patients.

Sections of the Anti-Fraud and Abuse Amendments to the Social Security Act, commonly known as the anti-kickback statute, prohibit certain business practices and relationships that might influence the provision and cost of healthcare services reimbursable under Medicaid, Medicare or other Federal healthcare programs, including the payment or receipt of remuneration for the referral of patients whose care will be funded by Medicare or other government programs. Sanctions for violating the anti-kickback statute include criminal penalties and civil sanctions, including fines and possible exclusion from future participation in government programs, such as Medicare and Medicaid. Pursuant to the

Medicare and Medicaid Patient and Program Protection Act of 1987, the U.S. Department of Health and Human Services (HHS) issued regulations that create safe harbors under the anti-kickback statute. A given business arrangement that does not fall within an enumerated safe harbor is not *per se* illegal; however, business arrangements that fail to satisfy the applicable safe harbor criteria are subject to increased scrutiny by enforcement authorities. The Health Insurance Portability and Accountability Act of 1996 (*HIPAA*) broadened the scope of the fraud and abuse laws by adding several criminal statutes that are not related to receipt of payments from a federal healthcare program. HIPAA created civil penalties for proscribed conduct, including upcoding and billing for medically unnecessary goods or services. These new laws cover all health insurance programs, private as well as governmental. In addition, HIPAA broadened the scope of certain fraud and abuse laws, such as the anti-kickback statute, to include not just Medicare and Medicaid services, but all healthcare services reimbursed under a Federal or state healthcare program. Finally, HIPAA established new enforcement mechanisms to combat fraud and abuse. These new mechanisms include a bounty system where a portion of the payment recovered is returned to the government agencies, as well as a whistleblower program, where a portion of the payment received is paid to the whistleblower. HIPAA also expands the categories of persons that may be excluded from participation in federal and state healthcare programs.

There is increasing scrutiny by law enforcement authorities, the Office of Inspector General of the HHS, the courts and the U.S. Congress of arrangements between healthcare providers and potential referral sources to ensure that the arrangements are not designed as mechanisms to exchange remuneration for patient-care referrals and opportunities. Investigators also have demonstrated a willingness to look behind the formalities of a business transaction to determine the underlying purpose of payments between healthcare providers and potential referral sources. Enforcement actions have increased, as is evidenced by highly publicized enforcement investigations of certain hospital activities.

In addition, provisions of the Social Security Act, known as the Stark Act, also prohibit physicians from referring Medicare and Medicaid patients to providers of a broad range of designated health services with which the physicians or their immediate family members have ownership or certain other financial arrangements. Certain exceptions are available for employment agreements, leases, physician recruitment and certain other physician arrangements. A person making a referral, or seeking payment for services referred, in violation of the Stark Act is subject to civil monetary penalties of up to $15 for each service; restitution of any amounts received for illegally billed claims; and/or exclusion from future participation in the Medicare program, which can subject the person or entity to exclusion from future participation in state healthcare programs.

Further, if any physician or entity enters into an arrangement or scheme that the physician or entity knows or should have known has the principal purpose of assuring referrals by the physician to a particular entity, and the physician directly makes referrals to such entity, then such physician or entity could be subject to a civil monetary penalty of up to $100. Many states have adopted or are considering similar legislative proposals, some of which extend beyond the Medicaid program, to prohibit the payment or receipt of remuneration for the referral of patients and physician self-referrals regardless of the source of the payment for the care.

The Federal False Claims Act and Similar State Laws

A significant factor affecting the healthcare industry today is the use of the Federal False Claims Act, 31 U.S.C. § § 3729 *et. seq*., and, in particular, actions brought by individuals on behalf of the United States under the qui tam or whistleblower provisions of the False Claims Act. Whistleblower provisions allow private individuals to bring actions on behalf of the United States alleging that the defendant has defrauded the Federal Government.

Violations of the False Claims Act are punishable by damages equal to three times the actual damages sustained by the government, plus mandatory civil penalties of between $6 and $11 for each separate false claim. Settlements entered prior to litigation usually involve a less severe damages methodology. There are many potential bases for liability under the False Claims Act. Liability often arises when an entity knowingly submits a false claim for reimbursement to the Federal Government. The False Claims Act defines the term knowingly broadly. Thus, although simple negligence will not give rise to liability under the False Claims Act, submitting a claim with reckless disregard for its truth or falsity constitutes a knowing submission under the False Claims Act and, therefore, will provide grounds for liability. In some cases whistleblowers or the Federal government have taken the position that providers who allegedly have violated other statutes, such as the anti-kickback statute and the Stark Act, likewise thereby have submitted false claims under the False Claims Act. A

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number of states have adopted their own false claims provisions as well as their own whistleblower provisions whereby a private party may file a civil lawsuit in state court on behalf of such state governments.

Emergency Medical Treatment and Active Labor Act.

All of our facilities are subject to the Emergency Medical Treatment and Active Labor Act (EMTALA) This federal law requires any hospital that participates in the Medicare program to conduct an appropriate medical screening examination of every person who presents himself to the hospital s emergency department for treatment and, if the patient is suffering from an emergency medical condition, to either stabilize that condition or make an appropriate transfer of the patient to a facility that can handle the condition. The obligation to screen and stabilize emergency medical conditions exists regardless of a patient s ability to pay for treatment. There are severe penalties under EMTALA if a hospital fails to screen or appropriately stabilize or transfer a patient or if the hospital delays appropriate treatment in order to first inquire about the patient s ability to pay. Penalties for violations of EMTALA include civil monetary penalties and exclusion from participation in the Medicare program. In addition, an injured patient, the patient s family or a medical facility that suffers a financial loss as a direct result of another hospital s violation of the law can bring a civil suit against the hospital.

In a final rule, effective November 10, 2003, CMS clarified when a patient is considered to be on a hospital s property for purposes of treating the person pursuant to EMTALA. CMS stated that off-campus facilities such as specialty clinics, surgery centers and other facilities that lack emergency departments should not be subject to EMTALA, but that these locations must have a plan explaining how the location should proceed in an emergency situation such as transferring the patient to the closest hospital with an emergency department. CMS further clarified that hospital-owned ambulances could transport a patient to the closest emergency department instead of to the hospital that owns the ambulance.

CMS rules did not specify on-call physician requirements for an emergency department, but provided a subjective standard stating that on-call hospital schedules should meet the hospital s and community s needs. CMS also did not directly address a number of issues, including whether EMTALA applies to direct admissions, individuals who come to a hospital pursuant to a physician s orders for a routine procedure, individuals who present themselves at a hospital s psychiatric department or delivery/labor department, and whether screening requirements apply to patients transferred from other facilities. Although we believe that our hospitals comply with EMTALA, we cannot predict whether CMS will implement new requirements in the future and whether we will be able to comply with any new requirements.

Environmental Regulations

The healthcare operations of SunLink generate medical waste that must be disposed of in compliance with federal, state and local environmental laws, rules and regulations. SunLink s operations also are subject to various other environmental laws, rules and regulations.

Healthcare Facility Licensing Requirements

SunLink s healthcare facilities are subject to extensive federal, state and local legislation and regulation. In order to maintain their operating licenses, healthcare facilities must comply with strict standards concerning medical care, equipment and hygiene. Various licenses and permits also are required in order to dispense narcotics, operate pharmacies, handle radioactive materials and operate certain equipment. All licenses, provider numbers, and other permits or approvals required to perform our hospital business operations are held by individual subsidiaries of SunLink. Each of our hospital operating subsidiaries operates only a single hospital. All of SunLink s hospitals, except the leased hospital in Dexter, Missouri, are fully accredited by JCAHO.

Utilization Review Compliance and Hospital Governance

SunLink s healthcare facilities are subject to, and comply with, various forms of utilization review. In addition, under the Medicare prospective payment system, each state must have a peer review organization to carry out a federally mandated system of review of Medicare patient admissions, treatments and discharges in hospitals. Medical and surgical services and physician practices are supervised by committees of staff doctors at each healthcare facility; are overseen by each healthcare facility s local governing board, the primary voting members of which are physicians and community members; and are reviewed by SunLink s quality assurance personnel. The local governing boards also help maintain standards for quality care, develop long-range plans, establish, review and enforce practices and procedures and approve the credentials and disciplining of medical staff members.

HIPAA Transaction, Privacy and Security Requirements.

HIPAA and federal regulations issued pursuant to HIPAA contain, among other measures, provisions that require us to implement modified or new computer systems, employee training programs and business procedures. The federal regulations are intended to encourage electronic commerce in the healthcare industry, provide for the confidentiality and privacy of patient healthcare information and ensure the security of healthcare information.

A violation of the HIPAA regulations could result in civil money penalties of $1 per incident, up to a maximum of $25 per person per year per standard. HIPAA also provides for criminal penalties of up to $50 and one year in prison for knowingly and improperly obtaining or disclosing protected health information, up to $100 and five years in prison for obtaining protected health information under false pretenses and up to $250 and ten years in prison for obtaining or disclosing protected health information with the intent to sell, transfer or use such information for commercial advantage, personal gain or malicious harm. Since there is no significant history of enforcement efforts by the federal government at this time, it is not possible to ascertain the likelihood of enforcement efforts in connection with the HIPAA regulations or the potential for fines and penalties, which may result from any violation of the regulations.

HIPAA Privacy Regulations

HIPAA provided that if Congress did not pass comprehensive health privacy legislation, the Secretary of HHS was required to issue regulations designed to protect the privacy of individually identifiable health information. Congress did not pass such legislation and HHS ultimately published final privacy regulations in 2000. The final privacy rule regulations contained technical corrections and additional clarifications designed to ensure that protections for patient privacy were implemented in a manner that maximizes privacy while not compromising either the availability or the quality of medical care. The regulations became effective in April 2001 and compliance was required by April 2003. In 2002, HHS published modifications to the privacy rule regulation. The regulations increased consumers control over their medical records, mandate substantial financial penalties for violation of a patient s right to privacy and, with a few exceptions, require that an individual s health information only be used for healthcare-related purposes. These privacy standards apply to all health plans, all healthcare clearinghouses and healthcare providers, such as our facilities, that transmit health information in an electronic form in connection with standard transactions, and apply to individually identifiable information held or disclosed by a covered entity in any form. These standards impose extensive administrative requirements on our facilities and require compliance with rules governing the use and disclosure of this health information, and they require our facilities to impose these rules, by contract, on any business associate to whom we disclose such information in order to perform functions on behalf of our facilities. In addition, our facilities will continue to remain subject to any state laws that are more restrictive than the privacy regulations issued under HIPAA. These laws vary by state and could impose stricter standards and additional penalties.

The HIPAA privacy regulations also require healthcare providers to implement and enforce privacy policies to ensure compliance with the regulations and standards. Under the direction of SunLink s Vice President,

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Technical and Compliance Services, and in conjunction with a private HIPAA consultant and HIPAA coordinators at each facility, individually tailored policies and procedures were developed and implemented and HIPAA privacy educational programs were presented to all employees and physicians at each facility prior to the compliance deadline. We believe we are in compliance with current HIPAA privacy regulations.

HIPAA Electronic Data Standards

The Administrative Simplification Provisions of HIPAA require the use of uniform electronic data transmission standards for all healthcare related electronic data interchange. These provisions are intended to streamline and encourage electronic commerce in the healthcare industry. Among other things, these provisions require healthcare facilities to use standard data formats and code sets established by HHS when electronically transmitting information in connection with certain transactions, including health claims and equivalent encounter information, healthcare payment and remittance advice and health claim status.

In 2000, HHS published final regulations establishing electronic data transmission standards that all healthcare providers and payors must use when submitting and receiving certain electronic healthcare transactions. When fully implemented, the uniform data transmission standards are designed to enable healthcare providers to exchange billing and payment information directly with the many payors thereby eliminating data clearinghouses and simplifying the interface programs necessary to perform this function. Compliance with these standards was required by October 2003. We believe that SunLink was fully compliant with the regulations and standards by the compliance date. We have implemented a new management information system at our facilities and at our corporate headquarters over the last several years and we believe that such system complies with HIPAA electronic data regulations and standards.

HIPAA Security Standards

The Administrative Simplification Provisions of HIPAA also required the implementation of a series of security standards for the protection of electronic health information. The final rule adopting HIPAA standards for the security of electronic health information required compliance by April 20, 2005. This final rule specifies a series of administrative, technical and physical security procedures for covered entities to use to assure the confidentiality of electronic protected health information. The standards are delineated into either required or addressable implementation specifications.

Under the direction of SunLink s Vice President, Technical and Compliance Services, and in conjunction with a consortium of rural hospitals, private HIPAA security consultants and HIPAA security officers at each facility, security assessments were performed, individually tailored plans to apply required or addressable solutions were implemented and a set of security policies and procedures were implemented. In addition, an individually tailored comprehensive disaster contingency plan was developed and adopted by each facility and a HIPAA security training program presented to all applicable personnel. SunLink believes it is in full compliance with all aspects of the HIPAA security regulations.

HIPAA National Provider Identifier

HIPAA also required HHS to issue regulations establishing standard unique health identifiers for individuals, employers, health plans and healthcare providers to be used in connection with standard electronic transactions. All healthcare providers, including our facilities, were required to obtain a new National Provider Identifier (NPI) to be used in standard transactions instead of other numerical identifiers by May 23, 2007. Our facilities have fully implemented use of a standard unique healthcare identifier by utilizing their employer identification number. HHS has not yet issued proposed rules that establish the standard for unique health identifiers for health plans or individuals. Once these regulations are issued in final form, we expect to have approximately one to two years to become fully compliant, but cannot predict the impact of such changes at this time. We cannot predict whether our facilities may experience payment delays during the transition to the new identifiers.

Conversion Legislation.

Many states, including some where we have hospitals and others where we may in the future acquire hospitals, have adopted legislation regarding the sale or other disposition of hospitals operated by not-for-profit entities. In other states that do not have specific legislation, state attorneys generally have demonstrated an interest in these transactions under their general obligations to protect charitable assets from waste. These legislative and administrative efforts primarily focus on the appropriate valuation of the assets divested and the use of the proceeds of the sale by the not-for-profit seller. These reviews and, in some instances, approval processes can add additional time to the closing of a hospital acquisition. There can be no assurance that future actions on the state level will not seriously delay or even prevent our ability to acquire hospitals. If these activities are widespread, they could limit our ability to acquire additional hospitals or increase our acquisition costs.

Professional Liability

As part of our business, we are subject to claims of liability for events occurring in the ordinary course of hospital operations. To cover these claims, we maintain professional malpractice liability insurance and general liability insurance in amounts, which are commercially available, that we believe are sufficient for our operations, although some claims may exceed the scope or amount of the coverage in effect.

In connection with the acquisition of our initial six community hospitals, SunLink assumed responsibility for general and professional liability claims reported after February 1, 2001 (our acquisition date of such hospitals), and the previous owner retained responsibility for all known and filed claims. We have purchased claims-made commercial insurance (with a substantial self-insured retention) for coverage prior to and after the acquisition date. The recorded liability for general and professional liability risks includes an estimate of the liability for claims incurred prior to February 1, 2001, but reported after February 1, 2001 and for claims incurred after February 1, 2001. In connection with the acquisition of HealthMont and its two hospitals, SunLink assumed responsibility for all professional liability claims. HealthMont had purchased claims-made commercial insurance for claims made prior to the acquisition. The recorded liability for professional liability risks includes an estimate of liability for claims assumed at the acquisition and for claims incurred after the acquisition. These estimates are based on actuarially determined amounts. In June 2004, SunLink sold Mountainside Medical Center, one of our initial six hospitals, but retained all liabilities and obligations arising from Mountainside s operations prior to the date of such sale and purchased a 7 year, claims-made, extended discovery period (tail) policy for potential professional liability claims relating to Mountainside.

Discontinued Operations and Related Contingent Obligations

Over the past 18 years we have discontinued operations carried on by our former Mountainside Medical Center and our former industrial and life sciences and engineering segments, and our former U.K. child safety, leisure marine, and housewares segments. SunLink s reserves relating to discontinued operations of these segments represent management s best estimate of our possible liability for property, product liability and other claims for which we may incur liability. These estimates are based on management s judgments using currently available information as well as, in certain instances, consultation with our 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. We intend to adjust our 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 the Company.

Beldray Limited

SunLink sold its former U.K. manufacturing subsidiary, Beldray Limited (Beldray), to two of Beldray s managers in October 2001. Beldray has since entered into administrative receivership. KRUG International U.K. Ltd. (KRUG UK), U.K. subsidiary of SunLink, entered into a guarantee (the Beldray Lease Guarantee) at a time when it owned Beldray. The Beldray Lease Guarantee covers Beldray s obligations under a lease of a portion of Beldray s former manufacturing location. In October 2004, KRUG UK received correspondence from the landlord of such facility 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 Lease 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 Lease Guarantee. On January 7, 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 made certain inquiries to SunLink and the subsidiary s directors regarding the activities of KRUG UK prior to the liquidation to which SunLink has responded.

On August 6, 2007, the liquidator of KRUG UK made an application in The Birmingham County Court in Birmingham, England, in which the liquidator is seeking a declaration by the court that certain transactions in 2001 from KRUG UK to SunLink in connection with the purchase of certain preferred stock of another subsidiary of SunLink and the making of a loan to SunLink, and certain deductions to debt owed to SunLink by KRUG UK were improper because KRUG UK was then effectively insolvent and the approval of such transactions by the then directors of KRUG UK resulted in a breach of their fiduciary duties. The liquidator seeks to have the court order the former directors or, in the alternative, the Company, to account for, or reverse such transactions to the liquidator of KRUG UK. A hearing on this application is set for October 2007. In connection with the allegations in the application of breach of fiduciary duty by the directors of KRUG UK in approving such transactions, SunLink has indemnification obligations to the former directors of KRUG UK. SunLink denies any liability to Krug UK other than to it in its status as a preferred stockholder and for the unpaid balance on the promissory note. SunLink, through its United Kingdom counsel, intends to vigorously defend against the liquidator s claims.

Employee and Labor Relations

As of June 30, 2007, SunLink employed 1,242 full-time and 510 part-time persons in the U.S., none of whom are represented by a union. We believe our labor relations generally are satisfactory.

Environmental Law Compliance

We believe we are in substantial compliance with applicable federal, state and local environmental regulations. To date, compliance with federal, state and local laws regulating the discharge of material into the environment or otherwise relating to the protection of the environment have not had a material effect upon our consolidated results of operations, consolidated financial condition or competitive position. Similarly, we have not had to make material capital expenditures to comply with such regulations.

EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers, as of September 21, 2007, their positions with the Company or its subsidiaries and their ages are as follows:

Name	Offices	Age
Robert M. Thornton, Jr.	Director, Chairman of the Board of Directors, President and Chief Executive Officer	58
Mark J. Stockslager	Chief Financial Officer and Principal Accounting Officer	48
Harry R. Alvis	Chief Operating Officer	62
Jerome D. Orth	Vice President, Technical and Compliance Services	59
Jack M. Spurr, Jr	Vice President, Hospital Financial Operations	62

All of our executive officers hold office for an indefinite term, subject to the discretion of the Board of Directors.

Robert M. Thornton, Jr. has been Chairman and Chief Executive Officer of SunLink Health Systems, Inc. since September 10, 1998, President since July 16, 1996 and was Chief Financial Officer from July 18, 1997 to August 31, 2002. From March 1995 to the present, Mr. Thornton has been a private investor in and Chairman and Chief Executive Officer of CareVest Capital, LLC, a private investment and management services firm. Mr. Thornton was President, Chief Operating Officer, Chief Financial Officer and a director of Hallmark Healthcare Corporation (Hallmark) from November 1993 until Hallmark s merger with Community Health Systems, Inc. in October 1994. From October 1987 until November 1993, Mr. Thornton was Executive Vice President, Chief Financial Officer, Secretary, Treasurer and a director of Hallmark.

Mark J. Stockslager has been SunLink s Chief Financial Officer since July 1, 2007. He was interim Chief Financial Officer from November 6, 2006 until June 30, 2007. He has been the Principal Accounting Officer since March 11, 1998 and was Corporate Controller from November 6, 1996 to June 4, 2007. He has been associated continuously with our accounting and finance operations since June 1988 and has held various positions, including Manager of U.S. Accounting, from June 1993 until November 1996. From June 1982 through May 1988, Mr. Stockslager was employed by Price Waterhouse & Co.

Harry R. Alvis has been Chief Operating Officer of SunLink Health Systems, Inc. since September 1, 2002 and Senior Vice President of Operations of SunLink Healthcare LLC. since February 1, 2001. Mr. Alvis provided turn-around operational consulting services for New America Healthcare Corp. from March 2000 through January 2001. From August 1997 through August 1999, Mr. Alvis was Chief Executive Officer of River Region Health Systems in Vicksburg, Mississippi, a healthcare facility owned by Quorum Health Group, Inc. From August 1995 through August 1997, Mr. Alvis was the Chief Executive Officer of Greenview Hospital in Bowling Green, Kentucky, a healthcare facility owned by Hospital Corporation of America. From November 1987 through August 1995, Mr. Alvis was the Chief Executive Officer of Pinelake Medical Center in Mayfield, Kentucky; a facility owned by HealthTrust, Inc.

Jerome D. Orth has been Vice President, Technical & Compliance Services for the Company since February 1, 2001. From January 1995 through January 2001, Mr. Orth was Vice President of Hospital Financial Operations for ValueMark Healthcare Systems, Inc., a privately-held owner-operator of psychiatric hospitals. From February 1987 through October 1994, Mr. Orth held various positions with Hallmark Healthcare Corporation, including Executive Director, Hospital Financial Management and Executive Director, Management Information Systems. Prior to 1987, Mr. Orth spent 12 years in various accounting, third party reimbursement and management positions with Hospital Corporation of America.

Jack M. Spurr, Jr. has been Vice President, Hospital Financial Operations for the Company since October 1, 2002. From February 1, 2001 until September 30, 2002, Mr. Spurr performed several interim financial roles for the Company. From 1978 to 2000, Mr. Spurr held financial positions with Hospital Corporation of America, Columbia Healthcare, Inc., Quorum Health Group, Inc., HealthTrust, Inc., and National Healthcare Inc.

Item 1A. ***Risk Factors***

In addition to other information contained in this Annual Report, including certain cautionary and forward-looking statements, you should carefully consider the following factors in evaluating an investment in SunLink:

SunLink has a limited operating history in the community hospital business and a limited history of profitability.

Prior to February 1, 2001, SunLink operated in different business segments. SunLink had income from continuing operations of $1,577 for the fiscal year ended June 30, 2007, $4,181 for the fiscal year ended June 30, 2006, $4,383 for the fiscal year ended June 30, 2005 and $1,560 for the fiscal year ended June 30, 2003. Conversely, SunLink had losses from continuing operations of $1,267 for the fiscal year ended June 30, 2004, $2,080 for the fiscal year ended June 30, 2002, $319 for the three month transitional period ended June 30, 2001, and $881 for the fiscal year ended March 31, 2001, respectively. SunLink may experience operating losses from continuing operations in the future.

SunLink s growth strategy depends in part on making successful acquisitions, via mergers, or otherwise, which may expose SunLink to new liabilities.

As part of its growth strategy, SunLink will seek further growth through acquisitions, via mergers or otherwise, of community hospitals to stay competitive with its increasingly larger competitors or to enhance its position in its core areas of operation. This strategy entails risks that could negatively affect SunLink s results of operations or financial condition. These risks include:

- unidentified liabilities of the companies SunLink may acquire or merge with;
- the possible inability to successfully integrate and manage acquired operations and personnel;
- the potential failure to achieve the economies of scale or synergies sought; and
- the diversion of management s attention away from other ongoing business concerns.

Acquired businesses may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations. Although SunLink has policies which require acquired facilities to implement SunLink compliance standards, and generally will seek indemnification from prospective sellers covering these matters, SunLink may become liable for past activities of acquired businesses.

Additional debt for significant capital investments may be required to achieve SunLink s operational and growth plans, the inability to access capital may affect SunLink s competitive position, reduce earnings, and negatively affect the value of your SunLink common stock.

SunLink s growth plans require significant capital investments. Significant capital investments are required for on-going and planned capital improvements at existing hospitals and may be required in connection with future capital projects either in connection with existing properties or future acquired properties. SunLink s ability to make capital investments depends on numerous factors such as the availability of funds from operations and its credit facility and access to additional debt and equity financing. No assurance can be given that the necessary funds will be available. Moreover, incurrence of additional debt financing, if available, may involve additional restrictive covenants that could negatively affect SunLink s ability to operate its business in the desired manner, and raising additional equity may be dilutive to shareholders. The failure to obtain funds necessary for the realization of SunLink s growth plans could prevent SunLink from realizing its growth strategy and, in particular, could force SunLink to forego acquisition opportunities that may arise in the future. This could, in turn, have a negative impact on SunLink s competitive position.

One element of SunLink s business strategy is expansion through the selective acquisitions of community hospitals in selected markets. The competition to acquire hospitals in the markets that SunLink targets is significant, and SunLink may not be able to make suitable acquisitions on terms favorable to it if other health-care companies, including those with greater financial resources, are competing for the same businesses. In order to make future acquisitions SunLink may be required to incur or assume additional indebtedness. SunLink may not be able to obtain financing, if necessary, for any acquisitions that it might desire to make or it might be required to borrow at higher rates and on less favorable terms than its competitors.

Many states have enacted or are considering enacting laws affecting sales, leases or other transactions in which control of not-for-profit hospitals is acquired by for-profit corporations. These laws, in general, include provisions relating to state attorney general approval, advance notification and community involvement. In addition, state attorneys general in states without specific legislation governing these transactions may exercise authority based upon charitable trust and other existing law. The increased legal and regulatory review of transactions involving the change of control of not-for-profit entities may increase the costs required, or limit SunLink s ability, to acquire not-for-profit hospitals.

SunLink s success depends on its ability to maintain good relationships with the physicians at its hospitals and, if SunLink is unable to successfully maintain good relationships with physicians, admissions and outpatient revenues at SunLink hospitals may decrease and SunLink s operating performance could decline.

Because physicians generally direct the majority of hospital admissions and outpatient services, SunLink s success is, in part, dependent upon the number and quality of physicians on the medical staffs of its hospitals, the admissions and referrals practices of the physicians at its hospitals, and its ability to maintain good relations with its physicians. Physicians at SunLink hospitals are generally not employees of the hospitals at which they practice and, in many of the markets that SunLink serves, most physicians have admitting privileges at other hospitals in addition to SunLink s hospitals. If SunLink is unable to successfully maintain good relationships with physicians, admissions at SunLink hospitals may decrease and SunLink s operating performance could decline.

SunLink depends heavily on its senior and local management personnel, and the loss of the services of one or more of SunLink s key senior management personnel or SunLink s key local management personnel could weaken SunLink s management team and its ability to deliver healthcare services.

SunLink has been, and will continue to be, dependent upon the services and management experience of its executive officers. If any of SunLink s executive officers were to resign their positions or otherwise be unable to serve, SunLink s management could be weakened and operating results could be adversely affected. In addition, SunLink s success depends on its ability to attract and retain managers at its hospitals and related facilities, on the ability of hospital-based officers and key employees to manage growth successfully, and on their ability to attract and retain skilled employees. SunLink has not had any material difficulties in attracting senior or local management and, to its knowledge, no key personnel intend to retire or terminate their employment with SunLink in the near future; however, if SunLink is unable to attract and retain affective local management, SunLink s operating performance could decline.

SunLink s success depends on its ability to attract and retain qualified healthcare professionals, and a shortage of qualified healthcare professionals in certain markets could weaken our ability to deliver healthcare services.

In addition to the physicians and management personnel whom SunLink employs, SunLink s operations are dependent on the efforts, ability, and experience of other healthcare professionals, such as nurses, pharmacists and lab technicians. Nurses, pharmacists, lab technicians and other healthcare professionals are generally employees of each individual SunLink hospital. SunLink s success has been, and will continue to be, influenced by its ability to attract and retain these skilled employees. A shortage of healthcare professionals in certain

markets, the loss of some or all of its key employees or the inability to attract or retain sufficient numbers of qualified healthcare professionals could cause SunLink s operating performance to decline.

A significant portion of SunLink s revenue is dependent on Medicare and Medicaid payments, and possible reductions in Medicare or Medicaid payments or the implementation of other measures to reduce reimbursements may reduce our revenues.

A significant portion of SunLink s revenues are derived from the Medicare and Medicaid programs, which are highly regulated and subject to frequent and substantial changes. SunLink derived approximately 81% of its patient days and 61% of its net patient revenues from the Medicare and Medicaid programs for the year ended June 30, 2007. Previous legislative changes have resulted in, and future legislative changes may result in, limitations on and reduced levels of payment and reimbursement for a substantial portion of hospital procedures and costs.

Future healthcare legislation or other changes in the administration or interpretation of governmental healthcare programs may have a material adverse effect on SunLink s business, financial condition, results of operations or prospects.

Revenue and profitability may be constrained by future cost containment initiatives undertaken by purchasers of healthcare services if SunLink is unable to contain costs.

SunLink derived approximately 39% of its net patient revenues for the fiscal year ended June 30, 2007 from private payors and other non-governmental sources who contributed approximately 19% of SunLink s patient days. SunLink s hospitals have been affected by the increasing number of initiatives undertaken during the past several years by all major purchasers of healthcare, including (in addition to Federal and state governments) insurance companies and employers, to revise payment methodologies and monitor healthcare expenditures in order to contain healthcare costs. Initiatives such as managed care organizations offering prepaid and discounted medical services packages have adversely affected hospital revenue growth throughout the country and such packages represent an increasing portion of SunLink s admissions and outpatient revenues and have resulted in reduced revenue growth at our hospitals. In addition, private payers increasingly are attempting to control healthcare costs through direct contracting with hospitals to provide services on a discounted basis, increased utilization review and greater enrollment in managed care programs such as health maintenance organizations and preferred provider organizations, referred to as PPOs. If SunLink is unable to contain costs through increased operational efficiencies and the trend toward declining reimbursements and payments continues, the results of its operations and cash flow will be adversely affected.

SunLink s revenues are heavily concentrated in Georgia which will make SunLink particularly sensitive to economic and other changes in the state of Georgia.

For the fiscal year ended June 30, 2007, our three Georgia hospitals generated approximately 48% of revenues for the year. Accordingly, any change in the current demographic, economic, competitive or regulatory conditions in the state of Georgia could have a material adverse effect on the business, financial condition, results of operations or prospects of SunLink.

SunLink faces intense competition from other hospitals and healthcare providers which directly affect our revenues, profitability and market share.

Although each of our hospitals operates in communities where they are currently the only general, acute care hospital, they do face competition from other hospitals, including larger tertiary care centers. Although these competing hospitals may be as far as 30 to 50 miles away, patients in these markets may migrate to these competing facilities as a result of local physician referrals, managed care plan incentives or personal choice.

The healthcare business is highly competitive and competition among hospitals and other healthcare providers for patients has intensified in recent years. Each of our hospitals operates in geographic areas where they compete with at least one other hospital that provides services comparable to those offered by our hospitals. Some of these competing facilities offer services, including extensive medical research and medical education programs, which are not offered by SunLink s facilities. Some of the competing hospitals are owned or operated by tax-supported governmental bodies or by private not-for-profit entities supported by endowments and charitable contributions which can finance capital expenditures on a tax-exempt basis and are exempt from sales, property, and income taxes. In some of these markets, SunLink s hospitals also face competition from other for-profit hospital companies, some of which have substantially greater resources, as well as other providers such as outpatient surgery and diagnostic centers.

The intense competition from other hospitals and other healthcare providers directly affects SunLink s revenues, profitability and market share.

SunLink conducts business in a heavily regulated industry; changes in regulations or violations of regulations may result in increased costs or sanctions that could reduce revenue and profitability.

The healthcare industry is subject to extensive Federal, state and local laws and regulations relating to:

- licensure;
- conduct of operations;
- ownership of facilities;
- addition of facilities and services;
- confidentiality, maintenance, and security issues associated with medical records;
- billing for services; and
- prices for services.

These laws and regulations are extremely complex and, in many instances, the industry does not have the benefit of significant regulatory or judicial interpretation of these laws and regulations, including in particular, Medicare and Medicaid anti-fraud and abuse amendments, codified in Section 1128B(b) of the Social Security Act and known as the anti-kickback statute. This law prohibits providers and others from soliciting, receiving, offering or paying, directly or indirectly, any remuneration with the intent to generate referrals of orders for services or items reimbursable under Medicare, Medicaid, and other Federal healthcare programs.

As authorized by Congress, HHS has issued regulations which describe some of the conduct and business relationships immune from prosecution under the anti-kickback statute. The fact that a given business arrangement does not fall within one of these safe harbor provisions does not render the arrangement illegal. However, business arrangements of healthcare service providers that fail to satisfy the applicable safe harbor criteria risk increased scrutiny by enforcement authorities.

We have a variety of financial relationships with physicians who refer patients to our hospitals. We have contracts with physicians providing services under a variety of financial arrangements such as employment contracts and professional service agreements. We also provide financial incentives, including loans and minimum revenue guarantees, to recruit physicians into the communities served by our hospitals.

HIPAA broadened the scope of the fraud and abuse laws to include all healthcare services, whether or not they are reimbursed under a Federal program. In addition, provisions of the Social Security Act, known as the Stark Act, also prohibit physicians from referring Medicare and Medicaid patients to providers of a broad range of designated health services in which the physicians or their immediate family members have an ownership interest or certain other financial arrangements.

In addition, SunLink s facilities will continue to remain subject to any state laws that are more restrictive than the regulations issued under HIPAA, which vary by state and could impose additional penalties. In recent years, both Federal and state government agencies have announced plans for or implemented heightened and coordinated civil and criminal enforcement efforts.

Government officials charged with responsibility for enforcing healthcare laws could assert that SunLink or any of the transactions in which the company or its subsidiaries or their predecessors is or was involved, are in violation of these laws. It is also possible that these laws ultimately could be interpreted by the courts in a manner that is different from the interpretations made by each company. A determination that either SunLink or its subsidiaries or their predecessors is or was involved in a transaction that violated these laws, or the public announcement that SunLink or its subsidiaries or their predecessors is being investigated for possible violations of these laws, could have a material adverse effect on SunLink s business, financial condition, results of operations or prospects and SunLink s business reputation could suffer significantly.

The laws, rules, and regulations described above are complex and subject to interpretation. In the event of a determination that we are in violation of any of these laws, rules or regulations, or if further changes in the regulatory framework occur, our results of operations could be significantly harmed.

SunLink s hospitals and other healthcare facilities are subject to, and depend on, certificate of need laws which could affect their ability to operate profitably.

All states in which SunLink currently operates hospitals have laws affecting acute care hospital facilities and services known as certificate of need laws. These states require prior approval for the acquisition of major medical equipment or the purchase, lease, construction, expansion, sale or closure of healthcare facilities, based on determination of need for additional or expanded facilities or services. The required approval is known generally as a CON. A CON may be required for capital expenditures exceeding a prescribed amount, changes in bed capacity or services, and certain other matters. The failure to obtain any required CON may impair SunLink s ability to operate profitably.

In addition, the elimination or modification of CON laws in states in which SunLink operates or in the future may own hospitals could subject its hospitals to greater competition making it more difficult to operate profitably.

SunLink is and in the future could be subject to claims related to discontinued operations and hospitals sold by our HealthMont subsidiary prior to its acquisition.

Over the past 18 years, SunLink has discontinued operations carried on by its former Mountainside Medical Center and its former industrial and life sciences and engineering segments, and U.K. child safety segments, leisure marine, and housewares segments. Prior to our acquisition of our HealthMont subsidiaries, HealthMont had sold two hospitals and it also disposed of one additional hospital as a condition to our acquisition of HealthMont. We also have disposed of one of our original hospitals. SunLink s reserves relating to discontinued operations represent management s best estimate of 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 SunLink s insurance carriers and legal counsel. SunLink currently does not purchase insurance policies to reduce product liability or other discontinued operations exposures and does not anticipate it will purchase such insurance in the future. 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. Furthermore, future events or evaluations could cause us to adjust existing reserves in connection with our operations. SunLink intends to adjust our estimates of required reserves from time to time as additional information is developed and evaluated. However, SunLink believes that the final resolution of known contingencies will not have a material adverse impact on its financial position, cash flows, or results of operations.

SunLink is subject to potential claims for professional liability, including claims based on the acts or omissions of third parties, which claims may not be covered by insurance.

SunLink is subject to potential claims for professional liability (medical malpractice), both in connection with our current operations, as well as acquired operations. To cover these claims, we maintain professional malpractice liability insurance and general liability insurance in amounts that we believe are sufficient for our operations, although some claims may exceed the scope or amount of the coverage in effect. The assertion of a significant number of claims, either within our self-insured retention (deductible) or individually or in the aggregate in excess of available insurance, could have a material adverse effect on our results of operations or financial condition. Premiums for professional liability insurance have historically been volatile and we can not assure you that professional liability insurance will continue to be available on terms acceptable to us, if at all. The operations of our hospitals also depend on the professional services of physicians and other trained healthcare providers and technicians in the conduct of their respective operations, including independent laboratories and physicians rendering diagnostic and medical services. There can be no assurance that any legal action stemming from the act or omission of a third party provider of healthcare services, would not be brought against one of our hospitals or SunLink, resulting in significant legal expenses in order to defend against such legal action or to obtain a financial contribution from the third-party whose acts or omissions occasioned the legal action.

SunLink may issue additional equity in the future which could dilute the value of shares of existing shareholders.

SunLink s working capital is limited to cash generated from operations and borrowings available under our $30,000 credit facility (of which approximately $15,300 is available to borrow at June 30, 2007) and our additional debt capacity is limited. Management and the board of directors of SunLink periodically have discussed the need to raise equity in the future and periodically have considered certain transactions which might be available to SunLink to raise equity. However, SunLink has not engaged any underwriter or placement agent with respect to any potential equity offering, nor has SunLink s management made any specific proposal or recommendation to the SunLink board of directors with respect to the type of securities to be offered or the price at which any securities might be offered. Such transactions might include among others the sale of common shares to outsiders or the offer to existing shareholders of the right to acquire additional shares. While the board of directors has not decided to effect any equity transaction at this time, it may do so in the future. Any equity transaction could result in dilution in the value of existing shares.

Forward-looking statements in this annual report may prove inaccurate.

This document contains forward-looking statements about SunLink that are not historical facts but, rather, are statements about future expectations. Forward-looking statements in this document are based on management s current views and assumptions and may be influenced by factors that could cause actual results, performance or events to be materially different from those projected. These forward-looking statements are subject to numerous risks and uncertainties. Important factors, some of which are beyond the control of SunLink, could cause actual results, performance or events to differ materially from those in the forward-looking statements. These factors include those described above under *Risk Factors* and elsewhere in this report under *Forward-Looking Statements*.

Items 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

Our principal properties as of the date of filing of this report are listed below:

Name or Function	Location City and State	Licensed Beds	Date of Acquisition/Lease Inception	Ownership Type
Healthcare Facilities				
Chilton Medical Center	Clanton, AL	60	February 1, 2001	Owned
Chestatee Regional Hospital	Dahlonega, GA	49	February 1, 2001	Owned
North Georgia Medical Center & Gilmer Nursing Home	Ellijay, GA	50	February 1, 2001	Owned
Trace Regional Hospital & Floy Dyer Manor Nursing Home	Houston, MS	84	February 1, 2001	Owned
Callaway Community Hospital	Fulton, MO	49	October 3, 2003	Owned
Memorial Hospital of Adel & Memorial Convalescent Center	Adel, GA	60	October 3, 2003	Owned
Missouri Southern Healthcare(1)	Dexter, MO	50	February 1, 2001	Leased
Other				
Corporate Offices(2)	Atlanta, GA	N/A	June 1, 1998	Leased
Medical Office Building	Jasper, GA	N/A	February 1, 2001	Owned

(1) The lease expires in March, 2019.
(2) Lease of approximately 6,100 square feet of office space for corporate staff. The lease expires in September 2009.

Item 3. ***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 for the reporting periods ended June 30, 2002, June 30, 2003 and May 31, 2004. Piedmont also seeks a declaratory judgment to the effect that PMH may retain certain payments it has received or likely will receive from the DCH s Indigent Care Trust Fund for Disproportionate Share Hospitals. Piedmont also seeks recovery of costs and attorney s fees pursuant to the Agreement and under Georgia Law.

On August 11, 2006, SunLink filed an Answer to the complaint asserting factual and legal defenses, along with a Counterclaim. In the Counterclaim, SHCJ alleges that PMH breached the Agreement by failing to reimburse SHCJ for certain Medicaid Cost Report adjustments for the reporting periods ended June 30, 1999, and June 30, 2000, as well as funds paid or expected to be paid to PMH from 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 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.

On August 6, 2007, the liquidator of KRUG UK made an application in The Birmingham County Court in Birmingham, England, in which the liquidator is seeking a declaration by the court that certain transactions in 2001 from KRUG UK to SunLink in connection with the purchase of certain preferred stock of another subsidiary of SunLink and the making of a loan to SunLink, and certain deductions to debt owed to SunLink by KRUG UK were improper because KRUG UK was then effectively insolvent and the approval of such transactions by the then directors of KRUG UK resulted in a breach of their fiduciary duties. The liquidator seeks to have the court order the former directors or, in the alternative, the Company, to account for, or reverse such transactions to the liquidator of KRUG UK. A hearing on this application is set for October 2007. In connection with the allegations in the application of breach of fiduciary duty by the then directors of KRUG UK in approving such transactions, SunLink has indemnification obligations to the former directors of KRUG UK. SunLink denies any liability to Krug UK other than to it in its status as a preferred stockholder and for the unpaid balance on the promissory note. SunLink, through its United Kingdom counsel, intends to vigorously defend against the liquidator s claims.

Item 4. ***Submission of Matters to a Vote of Security Holders***

Not applicable.

PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

SunLink common stock is listed on the American Stock Exchange. SunLink s ticker symbol is SSY . SunLink also has publicly traded warrants which trade in the over-the-counter market under the symbol SSYMW . The following table shows, for the calendar quarters indicated, based on published financial sources, the high and low sale prices of SunLink common shares as reported on the American Stock Exchange.

	Sale Prices of SunLink Common Shares	
	High	**Low**
Fiscal 2007 (July 1, 2006 June 30, 2007)		
Fourth Quarter	$ 7.35	$ 6.15
Third Quarter	7.30	6.65
Second Quarter	9.00	6.62
First Quarter	10.15	7.65
Fiscal 2006 (July 1, 2005 June 30, 2006)		
Fourth Quarter	$ 10.35	$ 9.30
Third Quarter	10.75	9.60
Second Quarter	10.90	8.03
First Quarter	8.79	7.60

American Stock Transfer & Trust Company is the Transfer Agent and Registrar for our common shares. For all shareholder inquiries, call American Stock Transfer & Trust s Shareholder Services Department at 1-888-937-5449.

Dividends

SunLink does not currently pay cash dividends. SunLink intends to retain its earnings for use in the operation and expansion of its business and, therefore, does not anticipate declaring or paying cash dividends in the foreseeable future. Any future determination to declare or pay cash dividends will be determined by SunLink s board of directors and will depend on SunLink s financial condition, results of operations, business, prospects, capital requirements, credit agreements and such other matters as the board of directors may consider relevant.

Holders

As of June 30, 2007 there were approximately 619 registered holders of SunLink common shares.

Securities Authorized for Issuance Under Equity Compensation Plans

The following provides tabular disclosure of the number of securities at June 30, 2007 to be issued upon the exercise of outstanding options, the weighted average exercise price of outstanding options and the number of securities remaining available for future issuance under equity compensation plans, reported by two categories- plans that have been approved by shareholders and plans that have not been so approved:

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)
Equity compensation plans approved by security holders:			
1995 Incentive Stock Option Plan	4,000	$ 5.48	0
2001 Outside Directors Stock Ownership and Stock Option Plan	82,500	$ 2.26	0
2001 Long-term Stock Option Plan	413,625	$ 2.94	0
2005 Equity Incentive Plan	241,906	$ 8.90	558,094
	742,031	$ 4.82	558,094
Equity compensation plans not approved by security holders:			
None	0	0	0
Total	742,031	$ 4.82	558,094

Performance Graph

The following graph presents a comparison of five years cumulative total return for SunLink, the American Stock Exchange Composite Index and the Hospitals Index. Hospitals Index consists of Amsurg Corp., Community Health Systems Inc., Dynacq Healthcare Inc., Health Management Association, Lifepoint Hospitals Inc., Magellan Health Services Inc., Medcath Corp., Paincare Holdings Inc., Rehabcare Group Inc., Tenet Healthcare Corp., and Universal Health Services Inc.

PERFORMANCE DATA

Cumulative Value of $100 invested on June 30, 2002

	6/02	6/03	6/04	6/05	6/06	6/07
SunLink Health Systems, Inc.	**100.00**	**76.51**	**176.19**	**250.16**	**314.29**	**200.63**
AMEX Composite	**100.00**	**103.59**	**136.43**	**168.84**	**184.93**	**236.58**
Hospitals Index	**100.00**	**44.89**	**55.97**	**64.56**	**48.84**	**53.86**

Item 6. ***Selected Financial Data***

Selected historical financial data presented below as of and for the fiscal years ended June 30, 2003, 2004, 2005, 2006 and 2007 have been derived from the audited consolidated financial statements of SunLink. The following financial information reflects the acquisition of our two HealthMont hospitals and the disposition of Mountainside Medical Center. This data should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements of SunLink and the notes thereto included in Item 8 of this Annual Report.

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SunLink Selected Historical Financial Data

(All amounts in thousands, except per share amounts)

	2003	2004	2005	2006	2007
Net revenues(a)	$ 80,742	$ 112,436	$ 128,732	$ 135,576	$ 143,645
Earnings (loss) from continuing operations	1,560	(1,267)	4,383	4,181	1,577
Net earnings	553	13,425	4,540	3,909	1,396
Earnings (loss) per share from continuing operations:					
Basic	0.31	(0.20)	0.61	0.58	0.21
Diluted	0.29	(0.20)	0.57	0.53	0.20
Net earnings per share:					
Basic	0.11	2.15	0.63	0.54	0.19
Diluted	0.10	2.15	0.59	0.50	0.18
Total assets	59,453	63,152	70,113	74,303	77,843
Long-term debt, including current maturities	25,518	7,392	10,042	9,393	8,536
Shareholders equity	$ 6,473	$ 24,904	$ 29,301	$ 34,352	$ 36,024

(a) All of SunLink s net revenues relate to its sole business segment, U.S. community hospitals. Net revenues for the periods presented represent only the revenues subsequent to the acquisition date for such hospitals. The operations of SunLink s other former business segments have been reported as discontinued operations and, therefore, have been excluded from the selected financial data of continuing operations presented above.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations (all dollar amounts in thousands, except per share and revenue per equivalent admissions amounts)***

This Annual Report and the documents that are incorporated by reference in this Annual 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, seeks to , expect, project, estimate, anticipate, plan or continue. These forward-looking stat the current plans and expectations and are subject to a number of risks, uncertainties and other factors which could significantly affect current plans and expectations and our future financial condition and results. These factors, which could cause actual results, performance and achievements to differ materially from those anticipated, include, but are not limited to:

General Business Conditions

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

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

demographic changes in areas where we operate hospitals;

the availability of cash or borrowing 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;

risks of changes in estimates of self insurance claims and reserves;

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

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

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

the functionality or costs with respect to our 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-K. 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 seek to pay but believes there may be opportunities for acquisitions of hospitals in the future due to, among other things, negative trends in certain government reimbursement programs and other factors. From time to time we may consider hospitals for disposition if we determine their operating results or potential growth no longer meet our strategic objectives.

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

Critical Accounting Estimates

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

- it requires assumptions to be made that were uncertain at the time the estimate was made; and
- changes in the estimate or different estimates that could have been made could have a material impact on our consolidated statement of earnings or financial condition.

The table of critical accounting estimates that follows is not intended to be a comprehensive list of all of our accounting policies that require estimates. We believe that of our significant accounting policies, as discussed in Note 2 of our Notes to Consolidated Financial Statements included in this Annual Report on Form 10-K for the fiscal year ended June 30, 2007, the estimates discussed below involve a higher degree of judgment and complexity. We believe the current assumptions and other considerations used to estimate amounts reflected in our consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts reflected in our consolidated financial statements, the resulting changes could have a material adverse effect on our consolidated results of operations and financial condition.

The table that follows presents information about our critical accounting estimates, as well as the effects of hypothetical changes in the material assumptions used to develop each estimate:

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
Receivables-net and Provision for Bad Debts		
Receivables-net primarily consists of amounts due from third-party payors and patients from providing healthcare services to hospital facility patients. Our ability to collect outstanding receivables is critical to our results of operations and cash flows. To provide for accounts receivable that could become uncollectible in the future, we establish an allowance for doubtful accounts to reduce the carrying value of such receivables to their estimated net realizable value. The primary uncertainty lies with accounts for which patients are responsible, which we refer to as patient responsibility accounts. These accounts include both amounts payable by uninsured patients and co-payments and deductibles payable by insured patients. Our allowance for doubtful accounts, included in our balance sheets as of June 30 was as follows: 2007 $10,197; and 2006 $8,931. Our provision for bad debts, included in our results of operations, was as follows : 2007 $19,580 2006 $14,987; and 2005 $11,979.	The largest component of bad debts in our patient accounts receivable relates to accounts for which patients are responsible, which we refer to as patient responsibility accounts. These accounts include both amounts payable by uninsured patients and co-payments and deductibles payable by insured patients. In general, we attempt to collect deductibles, co-payments and self-pay accounts prior to the time of service for non-emergency care. If we do not collect these patient responsibility accounts prior to the delivery of care, the accounts are handled through our billing and collections processes. We attempt to verify each patient s insurance coverage as early as possible before a scheduled non-emergency admission or procedure, including with respect to eligibility, benefits and authorization/pre-certification requirements, in order to notify patients of the estimated amounts for which they will be responsible. We attempt to verify insurance coverage within a reasonable amount of time for all emergency room visits and non-emergency urgent admissions in compliance with the Emergency Medical Treatment and Active Labor Act. In general, we utilize the following steps in collecting accounts receivable: if possible, cash collection of all or a portion of deductibles, co-payments and self-pay accounts prior to or at the time	A significant increase in our provision for doubtful accounts (as a percentage of revenues) would lower our earnings. This would adversely affect our results of operations, financial condition, liquidity and potentially our future access to capital. If net revenues during fiscal 2007 were changed by 1%, our 2007 after-tax income from continuing operations would change by approximately $747 or diluted earnings per share of $0.10. This is only one example of reasonably possible sensitivity scenarios. The process of determining the allowance requires us to estimate uncollectible patient accounts that are highly uncertain and requires a high degree of judgment. It is impacted by, among other things, changes in regional economic conditions, business office operations, payor mix and trends in private and federal or state governmental healthcare coverage.

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
Receivables-net and Provisions for Bad Debts (continued)	service is provided; billing and follow-up with third party payors; collection calls; utilization of collection agencies; sue to collect if the patient has the means to pay and chooses not to pay; and if collection efforts are unsuccessful, write off the accounts. Our policy is to write off accounts after all collection efforts have failed, which is typically no longer than 120 days after the date of discharge of the patient. Patient responsibility accounts represent the majority of our write-offs. All of our hospitals retain third-party collection agencies for billing and collection of delinquent accounts. At most of our hospitals, more than one collection agency is used to promote competition and improved performance. The selection of collection agencies and the timing of referral of an account to a collection agency vary among hospitals. Generally, we do not write off accounts prior to utilizing the services of a collection agency. Once collection efforts have proven unsuccessful, an account is written off from our patient accounting system against the allowance for doubtful accounts. We determine the adequacy of the allowance for doubtful accounts utilizing a number of analytical tools and benchmarks. No single statistic or measurement alone determines the adequacy of the allowance. We monitor the revenue trends by payor classification on a quarter-by-quarter basis along with the composition of our accounts receivable agings. This review is	

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
	focused primarily on trends in self-pay revenues, accounts receivable, co-payment receivables and historic payment patterns. In addition, we analyze other factors such assays revenue in accounts receivable and we review admissions and charges by physicians, primarily focusing on recently recruited physicians.	

				Days Outstanding[1]				
Payor Class	0-30	31-60	61-90	91-120	121-150	151-180	>180	Total
Medicare	$ 3,643	$ 589	$ 221	$ 141	$ 73	$ 39	$ 116	$ 4,822
Commercial	2,884	785	400	269	158	119	316	4,931
Medicaid	1,600	304	162	69	80	37	162	2,414
Self Pay	503	438	402	359	229	110	329	2,370
Total	$ 8,630	$ 2,116	$ 1,185	$ 838	$ 540	$ 305	$ 923	$ 14,537

1 The above table shows net patient accounts receivable aged from patient billing date and are grouped by classification of verified insurance coverage. The receivables are net of contractual allowances and allowance for doubtful accounts. Contractual allowances and the allowance for doubtful accounts are calculated by payor class and are not calculated by the aging from the patient billing date; therefore, these allowances have been allocated within the aging of the various payor classes based upon gross patient receivable amounts.

Revenue recognition / Net Patient Service Revenues We recognize revenues in the period in which services are provided. Patient receivables primarily consist of amounts due from third-party payors and patients. Amounts we receive for treatment of patients covered by governmental programs, such as Medicare and Medicaid, and other third-party payors, such as HMOs, PPOs and other private insurers, are determined pursuant to contracts or established government rates and are generally less than our established billing rates. Accordingly, our gross revenues and patient receivables are reduced to net amounts receivable pursuant to such contracts or government payment	Revenues are recorded at estimated amounts due from patients, third-party payors and others for healthcare services provided net of contractual discounts pursuant to contract or government payment rates. Estimates for contractual allowances are calculated using computerized and manual processes depending on the type of payor involved. In certain hospitals, the contractual allowances are calculated by a computerized system based on payment terms for each payor. In other hospitals, the contractual allowances are estimated manually using historical collections for	

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
Revenue recognition / Net Patient Service Revenues (continued) rates through an allowance for contractual discounts. Approximately 90.3% of our revenues during 2007 relate to discounted charges. The sources of these revenues were as follows (as a percentage of total revenues): Medicare 46.0%; Medicaid 15.1%; and Commercial insurance 29.2%	each type of payor. For all hospitals, certain manual estimates are used in calculating contractual allowances based on historical collections from payors that are not significant or have not entered into a contract with us. All contractual adjustments regardless of type of payor or method of calculation are reviewed and compared to actual experience on a periodic basis. Accounts receivable primarily consist of amounts due from third party payors and patients. Amounts we receive for the treatment of patients covered by HMOs, PPOs and other private insurers are generally less than our established billing rates. We include contractual allowances as a reduction to revenues in our financial statements based on payor specific identification and payor specific factors for rate increases and denials.	
	Governmental payors The majority of services performed on Medicare and Medicaid patients are reimbursed at predetermined reimbursement rates. The differences between the established billing rates (i.e., gross charges) and the predetermined reimbursement rates are recorded as contractual discounts and deducted from gross charges. Under this prospective reimbursement system, there is no adjustment or settlement of the difference between the actual cost to provide the service and the predetermined reimbursement rates.	**Governmental payors** Because the laws and regulations governing the Medicare and Medicaid programs are complex and subject to change, the estimates of contractual discounts we record could change by material amounts. Adjustments related to final settlements for revenues retrospectively increased our revenues by the following amounts: 2007 $266; 2006 $312; and 2005 $707.

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
Revenue recognition / Net Patient Service Revenues (continued)	Discounts for retrospectively cost-based revenues, which were more prevalent in periods before 2000, are estimated based on historical and current factors and are adjusted in future periods when settlements of filed cost reports are received. Final settlements under these programs are subject to adjustment based on administrative review and audit by third party intermediaries, which can take several years to resolve completely.	
	Commercial Insurance	**Commercial Insurance**
	For most managed care plans, contractual allowances estimated at the time of service are adjusted to actual contractual allowances as cash is received and claims are reconciled. We evaluate the following criteria in developing the estimated contractual allowance percentages: historical contractual allowance trends based on actual claims paid by managed care payors; review of contractual allowance information reflecting current contract terms; consideration and analysis of changes in payor mix reimbursement levels; and other issues that may impact contractual allowances.	If our overall estimated contractual discount percentage on all of our commercial revenues during 2007 were changed by 1%, our 2007 after-tax income from continuing operations would change by approximately $219. This is only one example of reasonably possible sensitivity scenarios. The process of determining the allowance requires us to estimate the amount expected to be received and requires a high degree of judgment. It is impacted by changes in managed care contracts and other related factors.
		A significant increase in our estimate of contractual discounts would lower our earnings. This would adversely affect our results of operations, financial condition, liquidity and future access to capital.

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Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
Goodwill and accounting for business combinations		
Goodwill represents the excess of the purchase price over the fair value of the net assets (including separately identified intangible assets) of acquired companies. Our goodwill included in our consolidated balance sheets as of June30, for the following years was as follows: 2007 $2,944; and 2006 $2,944. The goodwill resulted from the 2004 acquisition of HealthMont, Inc.	We follow the guidance in Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, and test goodwill for impairment using a fair value approach. We are required to test for impairment at least annually, absent some triggering event that would accelerate an impairment assessment. On an ongoing basis, absent any impairment indicators, we perform our goodwill impairment testing as of June 30 of each year. We determine fair value using widely accepted valuation techniques, including discounted cash flow and market multiple analyses. These types of analyses require us to make assumptions and estimates regarding future cash flows, industry economic factors and the profitability of future business strategies. The purchase price of acquisitions is allocated to the assets acquired and liabilities assumed based upon their respective fair values and is subject to change during the twelve month period subsequent to the acquisition date. We engage independent third-party valuation firms to assist us in determining the fair values of assets acquired and liabilities assumed at the time of acquisition. Such valuations require us to make significant estimates and assumptions, including projections of future events and operating performance.	We performed our annual testing for goodwill impairment as of June 30, 2006 and 2007 using the methodology described here, and determined that no goodwill impairment existed. If actual future results are not consistent with our assumptions and estimates, we may be required to record goodwill impairment charges in the future.

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	**Assumption / Approach Used (dollar amounts in thousands, except per share)**	**Sensitivity Analysis (dollar amounts in thousands, except per share)**
	Fair value estimates are derived from independent appraisals, established market values of comparable assets, or internal calculations of estimated future net cash flows. Our estimate of future cash flows is based on assumptions and projections we believe to be currently reasonable and supportable. Our assumptions take into account revenue and expense growth rates, patient volumes, changes in payor mix, and changes in legislation and other payor payment patterns.	
Professional and general liability Claims		
We are subject to potential medical malpractice lawsuits and other claims as part of providing healthcare services. To mitigate a portion of this risk, we have maintained insurance for individual malpractice claims exceeding a self-insured retention amount. For the period February 1, 2001 to February 20, 2002, the self-insured retention amount was $25 per individual claim. For the period February 21, 2002 to February 28, 2005, our self-insured retention level was $1,000 on individual malpractice claims. For the period March 1, 2005 to February 28, 2006, our self-insured retention level was $500 on individual malpractice claims. For the period March 1, 2006 to February 28, 2007 and March 1, 2007 to February 28, 2008, our self-insured retention level was or will be $750 on individual malpractice claims.	The reserve for professional and general liability claims is based upon independent actuarial calculations, which consider historical claims data, demographic considerations, severity factors and other actuarial assumptions in the determination of reserve estimates. The reserve for professional and general liability claims reflects the current estimate of all outstanding losses, including incurred but not reported losses, based upon actuarial calculations as of the balance sheet date. The loss estimates included in the actuarial calculations may change in the future based upon updated facts and circumstances.	Actuarial calculations include a large number of variables that may significantly impact the estimate of ultimate losses recorded during a reporting period. In determining loss estimates, professional judgment is used by each actuary by selecting factors that are considered appropriate by the actuary for our specific circumstances. Changes in assumptions used by our independent actuary with respect to demographics and geography, industry trends, development patterns and judgmental selection of other factors may impact our recorded reserve levels and our results of operations.
Each year, we obtain quotes from various malpractice insurers with respect to the cost of obtaining medical malpractice insurance coverage. We compare these quotes to our most recent actuarially	We revise our reserve estimation process by obtaining independent actuarial calculations quarterly. Our estimated reserve for professional and general liability claims will be significantly affected if current and future claims differ from historical trends. While we monitor reported	

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
Professional and general liability claims (continued)		
determined estimates of losses at various self-insured retention levels. Accordingly, changes in insurance costs affect the self-insurance retention level we choose each year. As insurance costs have increased in recent years, we have accepted a higher level of risk in self-insured retention levels. The reserve for professional and general liability claims included in our consolidated balance sheets as of June 30 was as follows: 2007 $2,762; and 2006 $3,775. The total expense for professional and general liability coverage, included in our consolidated results of operations, was as follows: 2007 $ 127; 2006 $ 782; and 2005 $3,802.	claims closely and consider potential outcomes as estimated by our independent actuaries when determining our professional and general liability reserves, the complexity of the claims, the extended period of time to settle the claims and the wide range of potential outcomes complicates the estimation process. In addition, certain states, including Georgia, have passed varying forms of tort reform which may attempt to limit the number and types of claims and the amount of some medical malpractice awards. If enacted limitations remain in place or if similar laws are passed in the states where our hospitals are located, our loss estimates could decrease. Conversely, liberalization of the number and type of claims and damage awards permitted under any such law applicable to our operations could cause our loss estimates to increase.	Changes in our initial estimates of professional and general liability claims are non-cash charges and accordingly, there would be no material impact currently on our liquidity or capital resources.

Balance Sheet or Income Statement **Caption/Nature of Critical Estimate Item** **(dollar amounts in thousands, except per share)**	**Assumption / Approach Used** **(dollar amounts in thousands, except per share)**	**Sensitivity Analysis** **(dollar amounts in thousands, except per share)**
Accounting for income taxes Deferred tax assets generally represent items that will result in a tax deduction in future years for which we have already recorded the tax benefit in our income statement. We assess the likelihood that deferred tax assets will be recovered from future taxable income. To the extent we believe that recovery is not probable, a valuation allowance is established. To the extent we establish a valuation allowance or increase this allowance, we must include an expense as part of the income tax provision in our results of operations. Our net deferred tax asset balance (net of valuation allowance) in our consolidated balance sheets as of June 30 for the following years was as follows: 2007 $1,745; and 2006 $1,366.	The first step in determining the deferred tax asset valuation allowance is identifying reporting jurisdictions where we have a history of tax and operating losses or are projected to have losses in future periods as a result of changes in operational performance. We then determine if a valuation allowance should be established against the deferred tax assets for that reporting jurisdiction. The second step is to determine the amount of the valuation allowance. We will generally establish a valuation allowance equal to the net deferred tax asset (deferred tax assets less deferred tax liabilities) related to the jurisdiction identified in the first step of the analysis. In certain cases, we may not reduce the valuation allowance by the amount of the deferred tax liabilities depending on the nature and timing of future taxable income attributable to deferred tax liabilities.	Our deferred tax assets exceeded our deferred tax liabilities by $1,745 as of June 30, 2007, excluding the impact of valuation allowances. We generated federal taxable income in fiscal years 2007, 2006 and 2005. Therefore, we believe that the likelihood of our not realizing the federal tax benefit of our net deferred tax assets is remote. The IRS may propose adjustments for items we have failed to identify as tax contingencies. If the IRS were to propose and sustain assessments equal to 10% of our taxable income for 2007, we would incur approximately $107 of additional tax payments for 2007 plus applicable penalties and interest.
Our valuation allowances for deferred tax assets in our consolidated balance sheets as of June 30 for the following years were as follows: 2007 $2,898; and 2006 $2,958. In addition, significant judgment is required in determining and assessing the impact of certain tax-related contingencies. We establish accruals when, despite our belief that our tax return positions are fully supportable, it is probable that we have incurred a loss related to tax contingencies and the loss or range of loss can be reasonably estimated. We adjust the accruals related to tax contingencies as part of our provision for income taxes in our results of operations based upon changing facts and circumstances, such as the progress of a tax audit, development of	In assessing tax contingencies, we identify tax issues that we believe may be challenged upon examination by the taxing authorities. We also assess the likelihood of sustaining tax benefits associated with tax planning strategies and reduce tax benefits based on management s judgment regarding such likelihood. We compute the tax on each contingency. We then determine the amount of loss, or reduction in tax benefits based upon the foregoing and reflect such amount as a component of the provision for income taxes in the reporting period.	

Balance Sheet or Income Statement Caption/Nature of Critical Estimate Item (dollar amounts in thousands, except per share)	Assumption / Approach Used (dollar amounts in thousands, except per share)	Sensitivity Analysis (dollar amounts in thousands, except per share)
Accounting for income taxes (continued) industry related examination issues, as well as legislative, regulatory or judicial developments. A number of years may elapse before a particular matter, for which we have established an accrual, is audited and resolved.	During each reporting period, we assess the facts and circumstances related to recorded tax contingencies. If tax contingencies are no longer deemed probable based upon new facts and circumstances, the contingency is reflected as a reduction of the provision for income taxes in the current period.	

Financial Summary

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

	Years Ended June 30,		
	2005	**2006**	**2007**
Net Revenues	$ 128,732	$ 135,576	$ 143,645
Cost of Patient Service Revenues	121,642	127,949	139,231
Operating Profit	7,090	7,627	4,414
Interest Expense	(1,110)	(1,146)	(1,462)
Interest Income	42	75	69
Loss on early repayment of debt	(384)		
Earnings from Continuing Operations Before Income Taxes	$ 5,638	$ 6,556	$ 3,021
Admissions	10,566	9,970	9,908
Equivalent Admissions	25,897	25,163	26,903
Surgeries	5,063	4,900	4,847
Revenue per Equivalent Admission	$ 4,971	$ 5,388	$ 5,339

Equivalent admissions Equivalent admissions is used by management (and certain investors) as a general approximation 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

All of our net revenues are from our U.S. community hospital segment. The operations of SunLink s former Mountainside Medical Center which was operated during these periods is reported in discontinued operations for all periods discussed.

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Net revenue for the year ended June 30, 2007 were $143,645 with a total of 26,903 equivalent admissions and revenues per equivalent admission of $5,339 compared to net revenues of $135,576, a total of 25,163 equivalent admissions and revenues per equivalent admission of $5,388 for the year ended June 30, 2006. The 6.0% increase in net revenues for the year ended June 30, 2007 was primarily from a 6.9% increase in equivalent admissions and a 30.2% increase in self pay net revenues. Net outpatient service revenues increased $8,474, a 14.2% increase from last year to $68,234 and increased to 47.6% of net revenues from 44.1% last year. Net revenues for the years ended June 30, 2007 and 2006 included $3,481 and $3,156, respectively, from state indigent care programs.

Net revenues for the year ended June 30, 2006 were $135,576, with a total of 25,163 equivalent admissions and revenues per equivalent admission of $5,388 compared to net revenues of $128,732, a total of 25,897 equivalent admissions and revenues per equivalent admission of $4,971 for the year ended June 30, 2005. The 5.3% increase in net revenues for the year ended June 30, 2006 was due to an increase in commercial insurance net revenues which increased 10.6% in the year ended June 30, 2006 and an 8.3% increase in revenue per equivalent admission resulting from price increases for most services at our hospitals. Net outpatient service revenues increased $5,260, a 9.7% increase from the year ended June 30, 2005 to $59,760 and increased to 44.1% of net revenues from 42.3% from the year ended June 30, 2005. Net revenues for the years ended June 30, 2006 and 2005 included $3,156 and $3,252, respectively, from state indigent care programs.

Recruitment of new doctors and spending for capital improvements have contributed greatly to the increase in net revenues in the years ended June 30, 2007, 2006 and 2005, respectively. We added seven net new doctors during the year ended June 30, 2007, 13 net new doctors during the year ended June 30, 2006, and six net new doctors during the year ended June 30, 2005. During the year ended June 30, 2007, SunLink expensed $1,098 on physician guarantees and recruiting expenses compared to $1,699 last year. We also have expended approximately $17,049 for capital expenditures to upgrade services and facilities since July 1, 2005. We believe the upgraded services and facilities and the new doctors contributed to the increase in net revenues for the years ended June 30, 2007 and 2006, respectively, compared to the prior years. 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 various payors in the Company s hospitals for the periods indicated:

	Years Ended June 30,		
	2005	2006	2007
Source			
Medicare	46.3%	46.0%	46.0%
Medicaid	17.2%	16.0%	15.1%
Self pay	7.8%	7.9%	9.7%
Commercial Insurance & Other	28.7%	30.1%	29.2%
	100.0%	100.0%	100.0%

During the fiscal year ended June 30, 2007, we experienced a decrease in Medicaid and Commercial Insurance and Other as a percentage of net revenues and an increase in Self-pay revenues. The changes were due primarily to increased patients without medical insurance, fewer patients qualifying for Medicaid and increasing deductibles and co-insurance required for insured patients. Medicare net revenues increased 6.0% in the fiscal year ended June 30, 2007 but were unchanged as a percentage of total net revenues in fiscal year 2007 compared to fiscal year 2006. During the fiscal year ended June 30, 2006, we experienced a decrease in Medicare as a percentage of net revenues and an increase in Self-pay and Commercial Insurance and other revenues. In each case, the changes were due primarily to increased managed care patients and increased out-patient revenues.

Cost of patient services revenues, including depreciation, were $139,231, $127,949, and $121,642, for the years ended June 30, 2007, 2006 and 2005, respectively.

	Cost of Patient Service Revenues as a of % of Net Revenue Years Ended June 30,		
	2005	2006	2007
Salaries, wages and benefits	48.3%	49.4%	49.1%
Provision for bad debts	9.3%	11.0%	13.6%
Supplies	11.0%	10.5%	10.8%
Purchased services	6.0%	6.4%	6.3%
Other operating expenses	15.7%	12.6%	12.1%
Rent and lease expense	2.2%	1.8%	1.9%

Salaries, wages and benefits expense as a percentage of net revenues decreased in the year ended June 30, 2007 compared to the prior year due to lower cost of defined contribution employee 401K plan and share option compensation expense. Provision for bad debts increased as a percentage of net revenue in the year ended June 30, 2007 compared to the prior year due to increases in charges for services rendered that could not be collected, overall decreased collections as a percentage of net revenues and higher self-pay net revenues during the year. Self-pay net revenues increased $3,224 or 30.2% in the year ended June 30, 2007 compared to the prior year. Supplies expense increased as a percentage of net revenues in the year ended June 30, 2007 compared to the prior year due to higher costs of supply items. Other operating expenses decreased as a percentage of net revenues in the year ended June 30, 2007 compared to the prior year due to lower expense for professional liability which includes the cost of insurance and lower actuarially-determined liability amounts.

Salaries, wages and benefits expense increased 1.1% as a percentage of net revenues in the year ended June 30, 2006 as compared to the prior year due to higher salary expense resulted from more staff and $577 of expense for share option compensation expense (0.4% of net revenues) as a result of the required adoption of SFAS No. 123(R). No share option compensation expense was recorded in the year ended June 30, 2005. Provision for bad debts increased as a percentage of net revenue in the year ended June 30, 2006 compared to the prior year due to increases in charges for services rendered that could not be collected, overall decreased collections as a percentage of net revenues and higher self-pay net revenues during the year. Self-pay net revenues increased $687 or 6.8% in the year ended June 30, 2006 compared to the prior year. Supplies expense decreased as a percentage of net revenues in the year ended June 30, 2006 compared to the prior year due to decreased admissions and surgeries. Other operating expenses decreased as a percentage of net revenues in the year ended June 30, 2006 compared to the prior year due to decreased insurance and physician recruiting expense. The decrease in insurance expense resulted from lower insurance costs and lower actuarially-determined liability for professional risks. Purchased services increased as a percentage of net revenues in the year ended June 30, 2006 compared to the prior year due to increased usage of outside services such as radiology, nuclear medicine and MRI.

Depreciation and amortization expense was $4,400, $3,400, and $2,590 for the years ended June 30, 2007, 2006, and 2005, respectively. The increase in fiscal years 2007 and 2006 depreciation and amortization expense resulted from the $17,049 spent for new equipment for all hospitals and the renovation of one facility over the past two fiscal years.

Interest expense was $1,462, $1,146, and $1,110 for the years ended June 30, 2007, 2006 and, 2005, respectively. The increase in fiscal years 2007 and 2006 interest expense resulted from higher outstanding debt amounts and interest rates on floating-rate debt.

Operating profit was $4,414, $7,627, and $7,090 for the years ended June 30, 2007, 2006 and, 2005, respectively. The decrease in operating profit in the year ended June 30, 2007 compared to the prior year was mainly due to significant increase in the bad debt provision and the increase in depreciation and amortization expense. The increase in operating profit in the year ended June 30, 2006 compared to the prior year was mainly due to the increase in net revenues and lower professional liability risks.

In October 2004, we repaid, from proceeds of a new $30,000 credit facility, mortgages totaling $4,025, due August 2005, a term note with a principal amount of $2,300, due August 2005 and a revolving loan with $1,289 outstanding. The early repayment resulted in a loss on early repayment of debt of $384. This loss is composed of $263 of unamortized prepaid debt costs related to the repaid debt instruments and a $121 penalty related to the early repayment of the revolving loan.

We recorded income tax expense of $1,444 ($1,272 federal and $172 state tax expense) for the year ended June 30, 2007 compared to income tax expense of $2,375 ($2,120 federal and $255 state tax expense) for the year ended June 30, 2006 and income tax expense of $1,255 ($1,126 federal and $129 state tax expense) for the year ended June 30, 2005. The $1,272 federal tax expense for the year ended June 30, 2007 included a $185 deferred tax benefit. The $2,120 federal tax expense for the year ended June 30, 2006 included a $147 deferred tax benefit. The $1,126 federal tax expense for the year ended June 30, 2005 included $69 of deferred income tax expense. We had an estimated net operating loss carry-forward for federal income tax purposes of approximately $7,300 at June 30, 2007. Use of this net operating loss carry-forward is subject to the limitations of the provisions of Internal Revenue Code Section 382. As a result, not all of the net operating loss carry-forward is available to offset federal taxable income in the current year. We have provided a valuation allowance for $2,898 of our $4,643 gross deferred tax asset (the majority of which is the net operating loss carry-forward for federal income tax purposes) as it is our assessment based upon the criteria identified in SFAS No. 109 that it is currently more likely than not that only $1,745 of the gross deferred tax asset will be realized through future taxable earnings or implementation of tax planning strategies.

Earnings from continuing operations were $1,577 ($0.20 per fully diluted share) for the year ended June 30, 2007 compared to earnings from continuing operations of $4,181 ($0.53 per fully diluted share) for the year ended June 30, 2006 and $4,383 ($0.57 per fully diluted share) for the year ended June 30, 2005. Earnings from continuing operations in fiscal 2007 decreased from fiscal 2006 due to decreased operating profit which resulted from higher provision for bad debts and depreciation and amortization expense and a higher effective income tax rate in fiscal 2007. Earnings from continuing operations in fiscal 2006 decreased from fiscal 2005 due to a higher effective income tax rate in fiscal 2006 due to lower net operating tax loss carry-forwards available in fiscal 2006. Earnings from continuing operations in fiscal 2006 decreased from fiscal 2005 due to a higher effective income tax rate in fiscal 2006 due to lower net operating tax loss carry-forwards available in fiscal 2006.

Loss from discontinued operations of $181 for the year ended June 30, 2007 resulted from $103 of losses after tax benefit from Mountainside, primarily due to legal expenses and $78 of after tax benefit losses resulting from domestic pension items. Loss from discontinued operations for the year ended June 30, 2006 of $272 resulted from $390 of losses after tax benefit from Mountainside, primarily due to $588 of unfavorable settlements of prior years Medicaid cost reports relating to periods prior to SunLink s sale of Mountainside, reduced by $118 of earnings of domestic pension items. Earnings from discontinued operations of $157 for the year ended June 30, 2005 included $276 of earnings after tax of Mountainside after its disposition, primarily due to collection of receivables in excess of allowances at the end of the prior fiscal year, reduced by $46 of domestic pension items and $73 of income tax expense related to the pension items.

Net earnings for the year ended June 30, 2007 were $1,396 ($0.18 per fully diluted share) compared to net earnings of $3,909 ($0.50 per fully diluted share) for the year ended June 30, 2006 and $4,540 ($0.59 per fully diluted share) for the year ended June 30, 2005.

Earnings before income taxes, interest, depreciation and amortization

Earnings before income taxes, interest, depreciation and amortization (Ebitda) represent the sum of income before income taxes, interest, 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 is an indicator of improved ability to service existing debt and to satisfy capital requirements. Ebitda, however, is not 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. Net cash provided by (used in) operations for the years ended June 30, 2007, 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.

	Years ended June 30,		
	2005	**2006**	**2007**
SHL Facilities Adjusted Ebitda	$ 12,449	$ 13,747	$ 10,236
HealthMont Facilities Adjusted Ebitda	1,472	2,556	2,629
Corporate overhead costs	(4,241)	(5,276)	(4,051)
Taxes and net interest expense	(2,323)	(3,446)	(2,837)
Other non-cash expenses and net changes in operating assets and liabilities	(5,132)	(3,075)	(1,228)
Net cash provided by operations	$ 2,225	$ 4,506	$ 4,749

Liquidity and Capital Resources

We generated $4,749 of cash from operations during the year ended June 30, 2007 compared to $4,506 from operations during the comparable period of the prior year. Cash was generated from net earnings, non-cash expenses of depreciation and amortization and stock-based compensation and decreased net patient receivables offset by decreased accounts payable and accrued expenses, increased prepaid and other current assets, cash used in discontinued operations and income taxes paid.

We generated $4,506 of cash from operations during the year ended June 30, 2006 compared to $2,225 from operations during the comparable period of the prior year. Cash was generated from net earnings, non-cash expenses of depreciation and amortization and stock-based compensation and increased accounts payable and accrued expenses, offset by increased net patient receivables, prepaid and other current assets and income taxes paid.

SunLink expended $9,037, $8,012, and $4,029 for capital expenditures at our hospitals (included in continuing operations) during the years ended June 30, 2007, 2006 and 2005, respectively. These capital expenditures were primarily for new and replacement equipment and the Dahlonega projects. We believe an attractive, up to date physical facility assists in recruiting quality staff and physicians, as well as attracting patients.

As of June 30, 2007, SunLink had approximately $1,382 in accounts payable for capital expenditures accepted prior to the quarter end. The Company has also begun a major renovation project at our Dahlonega, Georgia, facility which has an estimated cost of approximately $7,350, of which approximately $4,305 of cost has been paid or accrued to date and of which approximately $3,045 additional costs will be paid or accrued by the end of the current fiscal year. Except for the Dahlonega, Georgia major renovation, there are no other material future commitments for capital expenditures. In August 2007, the Company received final approval of a Certificate of Need application with the state of Georgia to build a replacement hospital in Ellijay, Georgia.

To date, SunLink has made no commitments related to the replacement hospital, however it has an option to purchase the land needed for the project which it expects to exercise in October 2007 at a cost of approximately $3,400.

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% (8.23% at 6/30/07), a $10,000 term loan (SunLink Term Loan A) with an interest rate at LIBOR plus 3.91% (9.23% at 6/30/07) 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 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 June 30, 2007 of approximately $28,222. Debt outstanding under the facility as of the fiscal year end June 30, 2007 was the SunLink Term Loan A of $8,222 and $4,700 of the revolving line of credit. SunLink may use the remaining funds from the initial draw and the funds available from the revolving line of credit for hospital capital projects and equipment purchases and for working capital needs. The Company began using the revolving line of credit during July 2006. Borrowing under the $5,000 SunLink Term Loan B may be used, subject to satisfaction of certain covenants, to satisfy certain claims or obligations with respect to discontinued operations, 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 the credit facility.

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 of approximately $28,222 at June 30, 2007, of which $8,222 was outstanding under a term loan and $4,700 was outstanding on a revolver loan. The current remaining availability of approximately $15,300 could be adversely affected by, among other things, the risk, uncertainties and other factors listed at the beginning of Item 7, as well as lower earnings due to lower demand for our services by patients, changes 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, the risks, uncertainties and other factors listed at the beginning of Item 7, as well as 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 related to long-term debt, non-cancelable operating leases, physician guarantees and interest on outstanding debt from continuing operations at June 30, 2007 is shown in the following table. The interest on variable interest debt is calculated at the interest rate in effect at June 30, 2007.

Payments Due in:	Long-Term Debt	Operating Leases	Physician Guarantees	Interest on Outstanding Debt
1 year	$ 875	$ 2,272	$ 348	$ 748
2 years	757	1,815	0	681
3 years	6,904	1,503	0	156
4 years	0	776	0	0
5 years	0	418	0	0
More than 5 years	0	1,661	0	0
	$ 8,536	$ 8,445	$ 348	$ 1,585

At June 30, 2007, SunLink had contracts with five 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 2 Summary of Significant Accounting Policies Recent Accounting Standards of the Consolidated Financial Statements in Item 7 of this Report 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. SunLink expensed $1,098, $1,699, and $2,259 for the fiscal years ended June 30, 2007, 2006 and 2005, respectively, for these guarantees.

At June 30, 2007, we had outstanding long-term debt of $8,536 of which $8,222 was incurred in connection with the SunLink Credit Facility and $314 was related to capital leases. At June 30, 2006, we had outstanding long-term debt of $9,393 of which $8,889 was incurred in connection with the SunLink Credit Facility and $504 was related to capital leases.

On July 13, 2006 Piedmont Healthcare, Inc. (Piedmont) 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 PMH), 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 SCH s Indigent Care Trust Fund for Disproportionate Share Hospitals, which payments Defendants contend qualify as excluded assets not sold to PMH under the Agreement. SHCJ also alleged that PMH breached the Agreement by failing to cooperate with SHCJ in an appeal of certain Medicaid Cost Reports settlements for the reporting period ended June 30, 2002, June 30, 2003 and May 31, 2004. SHCJ further alleged that Piedmont breached its obligations to 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 against liability 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

KRUG International U.K. Ltd. (KRUG UK), an inactive U.K. subsidiary of SunLink, entered into a guarantee (the Beldray Lease Guarantee) at a time when it owned Beldray Limited, a U.K. manufacturing business. The Beldray Lease Guarantee covers Beldray s obligations under a lease for a portion of Beldray s manufacturing location. 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 Lease 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 Lease Guarantee. On January 7, 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 made certain inquiries of SunLink regarding the activities of KRUG UK prior to the liquidation to which SunLink has responded.

On August 6, 2007, the liquidator of KRUG UK made an application in The Birmingham County Court in Birmingham, England, in which the liquidator is seeking a declaration by the court that certain transactions in 2001 from KRUG UK to SunLink in connection with the purchase of certain preferred stock of another subsidiary of SunLink and the making of a loan to SunLink, and certain deductions to debt owed to SunLink by KRUG UK were improper because KRUG UK was then effectively insolvent and the approval of such transactions by the then directors of KRUG UK resulted in a breach of their fiduciary duties. The liquidator seeks to have the court order the former directors or, in the alternative, the Company, to account for, or reverse such transactions to the liquidator of KRUG UK. A hearing on this application is set for October 2007. In connection with the allegations in the application of breach of fiduciary duty by the directors of KRUG UK in approving such transactions, SunLink has indemnification obligations to the former directors of KRUG UK. SunLink denies any liability to Krug UK other than to it in its status as a preferred stockholder and for the unpaid balance on the promissory note. SunLink, through its United Kingdom counsel, intends to vigorously defend against the liquidator s claims.

SunLink s non-current liability reserves for discontinued operations at June 30, 2007, included a reserve for a portion of the Beldray Guarantee. Such reserve was based upon management s estimate, after consultation with its property consultants and legal counsel, of the cost to satisfy the Beldray Guarantee in light of KRUG UK s limited assets and before taking into account any other claims against KRUG UK. The maximum potential obligation of KRUG UK for rent under the Beldray Guarantee is estimated to be approximately $8,400. As a result of this claim and the U.K. liquidation proceedings against KRUG UK, SunLink expects KRUG UK to be wound-up in liquidation in the UK and has fully reserved for any assets of KRUG UK.

Additional contingent obligations, other than with respect to our existing operations, include potential product liability claims for products manufactured and sold before the disposal of our discontinued industrial segment in fiscal 1989 and for guarantees of certain obligations of former subsidiaries. We have provided an accrual at June 30, 2007 related to the Beldray Lease Guarantee, as discussed above. We are currently in the process of liquidating two dormant subsidiaries in Germany and France. 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.

Sarbanes-Oxley Section 404

We incurred incremental costs related to compliance with Sarbanes-Oxley during the years ended June 30, 2007 and 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, 2008 and subsequent fiscal years.

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 as of June 30, 2008, and our independent auditors to attest to as of June 30, 2009, our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). As a consequence, we anticipate incurring expenses in the range of $400 $600 in the fiscal year ending June 30, 2008, 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.

Recent Accounting Pronouncements

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

FSP FIN 45-3 is effective for new minimum revenue guarantees issued or modified on or after January 1, 2006. The Company adopted FSP FIN 45-3 effective January 1, 2006. SunLink s accounting policy for physician guarantees issued prior to January 1, 2006 was to expense guarantees as they were paid. However, under FSP FIN 45-3, the Company expenses the advances paid to physicians over the period of the physician recruiting agreement, which is typically two to three years. The expense recorded for physician guarantees accounted for under FSP FIN 45-3 during the fiscal years ended June 30, 2007 and 2006 was $629 and $41 less than would have been expensed using the Company s previous accounting policy.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140, which simplifies accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid instrument that contains an embedded

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

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

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

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

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements Nos. 87, 88, 106, and 132(R), which requires a business entity to recognize the overfunded or underfunded status of a single-employer defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in comprehensive income in the year in which the changes occur. SFAS No. 158 also requires a business entity to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The Company adopted SFAS 158 at the end of the fiscal year ended June 30, 2007 with no effect on the consolidated statement of earnings. The pension asset recognized in the consolidated balance sheet at June 30, 2007 was reduced by $380, the amount of the unrecognized actuarial loss for that date as determined under FASB Statement No. 87. An offsetting $380 pre-tax amount was recorded in shareholders equity in accumulated other comprehensive loss.

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

In September 2006, the U.S. Securities and Exchange Commission (SEC) staff added Section N to Staff Accounting Bulletin (SAB) Topic 1 through the issuance of SAB 108 Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements). SAB 108 addresses how a company should evaluate whether an error in its financial statements is

material. The guidance in SAB 108 will be effective for annual financial statements with fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our consolidated results of operations or our consolidated financial position.

Related Party Transactions

A director of the Company and the Company s secretary (who was a director of SunLink until November 2003 and is now director emeritus) are members of two different law firms, each of which provides services to SunLink. We have paid an aggregate of $624, $564, and $655 to these law firms in the fiscal years ended June 30, 2007, 2006 and 2005, respectively. Another director received $3 in the fiscal year ended June 30, 2005 as a fee for being a letter of credit obligor for up to $200 of SunLink s revolving credit loans assumed in the HealthMont acquisition. The letter of credit obligation expired in September 2004.

Inflation

During periods of inflation and labor shortages, employee wages increase and suppliers pass along rising costs to us in the form of higher prices for their supplies and services. We have not always been able to offset increases in operating costs by increasing prices for our services and products or by implementing cost control measures. We are unable to predict our ability to control future cost increases or offset future cost increases by passing along the increased cost to customers.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

We are exposed to interest rate changes, primarily as a result of borrowing under the SunLink Credit Facility completed in October 2004. Borrowings of $12,922 at June 30, 2007 were outstanding under the SunLink Credit Facility at interest rates based upon LIBOR. A one percent change in the LIBOR rate would result in a change in interest expense of $129 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 8. ***Financial Statements and Supplementary Data***

Index to Financial Statements and Supplementary Data

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

Item 9A. ***Controls and Procedures***

(a) Evaluation of disclosure controls and procedures Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of the Company s disclosure controls and procedures (as such term is defined in the Securities Exchange Act of 1934, Rules 13a-15(e)and 15d-15(e) as of June 30, 2007 (the Evaluation Date), have concluded that as of the Evaluation Date, our disclosure controls and procedures were adequate and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within those entities.

(b) Changes in internal controls There were no significant changes in our internal controls or, to our knowledge, in other factors that could significantly affect our disclosure controls and procedures subsequent to June 30, 2007.

Item 9B. ***Other Information***

None.

PART III

Item 10. ***Directors and Executive Officers of the Registrant***

Audit Committee Financial Expert

We have a separately-designated standing audit committee established in accordance with section 3(a)(58) (A) of the Securities Exchange Act of 1934. The members of our Committee are Messrs. Ford (Chairman) and Hall and Ms. Brenner. All three members of the committee are independent as defined in Section 121(A) of the American Stock Exchange s listing standards. Our Board of Directors has determined that we have at least one audit committee financial expert as defined under Item 401(h) of Regulation S-K serving on our audit committee. Mr. Ford is an audit committee financial expert and is independent as defined under the applicable SEC and American Stock Exchange Rules.

Code of Ethics

We have adopted a Code of Ethics (SunLink Health Systems, Inc. Code of Conduct) within the meaning of Item 406(b) of Regulation S-K. The Code of Ethics applies to all employees including our principal executive officer, principal financial officer and principal accounting officer. The Code of Ethics is publicly available on our website at www.sunlinkhealth.com or upon request by writing to us. If we make substantial amendments to our Code of Ethics or grant any waiver for the three previously named individuals, including any implicit waivers, we will disclose the nature of such amendment or waiver on our website or in a report on Form 8-K within five days of such amendment or waiver.

Other Information

Certain information required by this Item 10 will be set forth in the Company s Proxy Statement for its Annual Meeting of Shareholders scheduled to be held on November 12, 2007, except for certain information concerning the executive officers of the Company which is set forth in Part I of this Report.

Item 11. ***Executive Compensation***

The information required by this Item 11 will be set forth in the Company s Proxy Statement for its Annual Meeting of Shareholders scheduled to be held on November 12, 2007, and is incorporated herein by this reference.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this Item 12 will be set forth in the Company s Proxy Statement for its Annual Meeting of Shareholders scheduled to be held on November 12, 2007, and is incorporated herein by this reference.

Item 13. ***Certain Relationships and Related Transactions***

The information required by this Item 13 will be set forth in the Company s Proxy Statement for its Annual Meeting of Shareholders scheduled to be held on November 12, 2007, and is incorporated herein by this reference.

Item 14. ***Principal Accountant Fees and Services***

The information required by this Item 14 will be set forth in the Company s Proxy Statement for its Annual Meeting of Shareholders scheduled to be held on November 12, 2007, and is incorporated herein by this reference.

PART IV

Item 15. ***Exhibits, Financial Statement Schedules and Reports on Form 8-K***

(a) (1) Financial Statements

The following consolidated financial statements of the Company and its subsidiaries are set forth in Item 8 of this Annual Report on Form 10-K.

Report of Independent Registered Public Accounting Firm.

Consolidated Balance Sheets June 30, 2007 and 2006.

Consolidated Statements of Earnings For the Years Ended June 30, 2007, 2006 and 2005.

Consolidated Statements of Shareholders Equity For the Years Ended June 30, 2007, 2006 and 2005.

Consolidated Statements of Cash Flows For the Years Ended June 30, 2007, 2006 and 2005.

Notes to Consolidated Financial Statements For the Years Ended June 30, 2007, 2006 and 2005.

(a) (2) Financial Statement Schedules

Report of Independent Registered Public Accounting Firm	At page 66 of this Report.
Schedule II Valuation and Qualifying Accounts	At page 67 of this Report.

The information required to be submitted in Schedules I, III, IV and V for SunLink Health Systems, Inc. and its consolidated subsidiaries has either been shown in the financial statements or notes, or is not applicable or not required under Regulation S-X and, therefore, has been omitted.

(b) Reports on Form 8-K

Date of Report	**Subject of Report**
May 14, 2007	Press release announcing financial results for the third quarter of fiscal 2007.

(c) Exhibits

The following exhibits are filed with this Form 10-K or incorporated herein by reference from the document set forth next to the exhibit in the list below:

2.1

	Asset Purchase Agreement, dated April 9, 2004, by and among Piedmont Mountainside Hospital, Inc., Piedmont Medical Center, Inc., Southern Health Corporation of Jasper, Inc., Southern Health Corporation, SunLink Healthcare Corp. and SunLink Health Systems, Inc. (incorporated by reference from Exhibit 2.1 of the Company s Report on Form 8-K dated April 14, 2004).
3.1	Amended Articles of Incorporation of SunLink Health Systems, Inc. (incorporated by reference from Exhibit 3.1 of the Company s Report on Form 10-Q for the quarter ended September 30, 2001).
3.2	Code of Regulations of SunLink Health Systems, Inc., as amended (incorporated by reference from Exhibit 3.2 of the Company s Report on Form 10-Q for the quarter ended September 30, 2001).
3.3	Certificate of Amendment to Amend Article Fourth of the Amended Articles of Incorporation of SunLink Health Systems, Inc. dated February 13, 2004 (incorporated by reference from Exhibit 3.1 of the Company s Report on Form 10-Q dated February 17, 2004).
4.1	Shareholder Rights Agreement dated as of February 8, 2004, between SunLink Health Systems, Inc. and Wachovia Bank, N.A., as Rights Agent (incorporated by reference from Exhibit 4.1 of the Company s Report on Form 8-K dated February 10, 2004).

10.1*	1995 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.3 of the Company s Report on Form 10-K for the year ended March 31, 1996).
10.2	Rent Review Memorandum between Rootmead Limited, Beldray Limited and KRUG International (UK) Limited dated August 30, 2000 (incorporated by reference from Exhibit 10.1 of the Company s Report on Form 10-Q dated September 30, 2001).
10.3	Counterpart/Reversionary Lease between Rootmead Limited, Beldray Limited and KRUG International (UK) Limited dated August 30, 2000 (incorporated by reference from Exhibit 10.2 of the Company s Report on Form 10-Q dated September 30, 2001).
10.4	Pre-emption Agreement between Rootmead Limited, Beldray Limited and KRUG International (UK) Limited dated August 30, 2000 (incorporated by reference from Exhibit 10.3 of the Company s Report on Form 10-Q dated September 30, 2001).
10.5	Lease between Barton Industrial Park Limited, Beldray Limited and Butterfield-Harvey Limited dated June 8, 1979 (incorporated by reference from Exhibit 10.4 of the Company s Report on Form 10-Q dated September 30, 2001).
10.6*	2001 Long-Term Stock Option Plan (incorporated by reference from Exhibit 10.5 of the Company s Report on Form 10-Q dated September 30, 2001).
10.7*	2001 Outside Directors Stock Ownership and Stock Option Plan (incorporated by reference from Exhibit 10.6 of the Company s Report on Form 10-Q dated September 30, 2001).
10.8	Agreement relating to the sale and purchase of the whole of the issued share capital of Beldray Limited dated 30 August, 2001, between Bradley International Holdings Limited and Marshall Cooper and John Clegg (incorporated by reference from Exhibit 10.1 of the Company s Report on Form 8-K dated October 15, 2001).
10.9	Variation relating to the sale and purchase of the whole of the issued share capital of Beldray Limited dated 30 August, 2001, dated 3 October, 2001, between Bradley International Holdings Limited and Marshall Cooper and John Clegg (incorporated by reference from Exhibit 10.2 of the Company s Report on Form 8-K dated October 15, 2001).
10.10*	Amended and Restated Employment Agreement between SunLink Health Systems, Inc. and J. T. Morris, dated February 1, 2002 (incorporated by reference from Exhibit 10.2 of SunLink s Form 10-Q for the quarter ended September 30, 2002).
10.11*	Employment Letter, dated April 30, 2001, by and between SunLink Health Systems, Inc. and Mark Stockslager (incorporated by reference from Exhibit 10.29 of SunLink s Form 10-Q for the quarter ended September 30, 2005).
10.12*	Employment Letter, dated February 1, 2001, by and between SunLink Healthcare Corp. and Jerome Orth (incorporated by reference from Exhibit 10.30 of SunLink s Form 10-Q for the quarter ended September 30, 2005).
10.13	Credit Agreement between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.73 of the Company s Report on Form 8-K dated October 21, 2004).
10.14	Form of Revolving Note between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc.,

	HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.74 of the Company s Report on Form 8-K dated October 21, 2004).
10.15	Form of Term Loan A Note between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.75 of the Company s Report on Form 8-K dated October 21, 2004).
10.16	Form of Term Loan B Note between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.76 of the Company s Report on Form 8-K dated October 21, 2004).
10.17	Form of Security Agreement between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.77 of the Company s Report on Form 8-K dated October 21, 2004).
10.18	Form of Pledge Agreement between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.78 of the Company s Report on Form 8-K dated October 21, 2004).
10.19*	Letter agreement, dated March 9, 2005, between J. T. Morris, SunLink Health Systems, Inc. and SunLink Healthcare, LLC (incorporated by reference from Exhibit 10.2 of the Company s Report on Form 8-K dated March 11, 2005).
10.20*	Amended and Restated Employment Agreement, dated July 1, 2005, between Harry R. Alvis and SunLink Health Systems, Inc. (incorporated by reference from Exhibit 99.1 of the Company s Report on Form 8-K dated December 8, 2005).
10.21*	Amended and Restated Employment Agreement, dated July 1, 2005, between Robert M. Thornton, Jr. and SunLink Health Systems, Inc. (incorporated by reference from Exhibit 99.1 of the Company s Report on Form 8-K dated December 23, 2005).
10.22*	Letter Agreement, dated March 13, 2006, between J. T. Morris, SunLink Health Systems, Inc. and SunLink Healthcare, LLC (incorporated by reference from Exhibit 10.1 of the Company s Report on Form 8-K dated March 14, 2005).
10.23	2005 Equity Incentive Plan (incorporated by reference from Exhibit 99.1 of the Company s Report on Form S-8 dated September 20, 2006).

10.24*	Separation Agreement, dated December 21, 2006, between J. T. Morris and SunLink Health Systems, Inc. (incorporated by reference from Exhibit 99.1 of the Company s Report on Form 8-K dated December 28, 2006).
10.25	Agreement of Understanding, dated June 28, 2007, between Christopher H. B. Mills and SunLink Health Systems, Inc. (incorporated by reference from Exhibit 99.2 of the Company s Report on Form 8-K dated July 16, 2007).
10.26	Form of Limited Consent Agreement, dated May 3, 2007, between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation, LLC.
10.27*	Employment Letter, dated September 30, 2002, by and between SunLink Healthcare Corp. and Jack M. Spurr, Jr.
21.1	List of Subsidiaries.
23.1	Consent of Cherry, Bekaert & Holland, L.L.P.
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.

* Management contract or compensatory plan or arrangement.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on this 24th day of September, 2007.

SUNLINK HEALTH SYSTEMS, INC.

By: /s/ ROBERT M. THORNTON, JR.
Robert M. Thornton, Jr.

Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of SunLink Health Systems, Inc. and in the capacities and on the dates indicated:

Name	Title	Date
/s/ ROBERT M. THORNTON, JR. **Robert M. Thornton, Jr.**	Director, Chairman, President and Chief Executive Officer (principal executive officer)	September 24, 2007
/s/ MARK J. STOCKSLAGER **Mark J. Stockslager**	Chief Financial Officer and Principal Accounting Officer (principal accounting officer)	September 24, 2007
/s/ STEVEN J. BAILEYS, D.D.S. **Steven J. Baileys, D.D.S.**	Director	September 24, 2007
/s/ KAREN B. BRENNER **Karen B. Brenner**	Director	September 24, 2007
/s/ GENE E. BURLESON **Gene E. Burleson**	Director	September 24, 2007
/s/ C. MICHAEL FORD **C. Michael Ford**	Director	September 24, 2007
/s/ MICHAEL HALL **Michael Hall**	Director	September 24, 2007
/s/ CHRISTOPHER H. B. MILLS **Christopher H. B. Mills**	Director	September 24, 2007
/s/ HOWARD E. TURNER	Director	September 24, 2007

Howard E. Turner

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders of

SunLink Health Systems, Inc.

We have audited the consolidated financial statements of SunLink Health Systems, Inc. and subsidiaries (the Company) as of June 30, 2007 and 2006 and for each of the three years in the period ended June 30, 2007 and have issued our report thereon dated September 21, 2007; such financial statements and report are included elsewhere in this Form 10-K. Our audits also included the consolidated financial statement schedules of the Company, listed in Item 15 for each of the three years in the period ended June 30, 2007. These consolidated financial statement schedules are the responsibility of the Company s management. Our responsibility is to express an opinion based on our audits. In our opinion, such consolidated financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

/s/ Cherry, Bekaert & Holland, L.L.P.

Atlanta, Georgia

September 21, 2007

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

amounts in thousands

Column A	Column B	Column C		Column D	Column E
Allowance for Doubtful Accounts	**Balance at Beginning of Year**	**Charged to Cost and Expenses**	**Currency Translation/ Acquisition/ (Disposition)**	**Deductions from Reserves**	**Balance at End of Year**
Year Ended June 30, 2007	$ 8,931	$ 19,580	$ 0	$ 18,314	$ 10,197
Year Ended June 30, 2006	$ 7,348	$ 14,987	$ 0	$ 13,404	$ 8,931
Year Ended June 30, 2005	$ 8,140	$ 11,060	$ 0	$ 11,852	$ 7,348

Deferred Income Tax Asset Valuation Allowance	**Balance at Beginning of Year**	**Charged to Cost and Expenses**	**Currency Translation/ Acquisition/ (Disposition)**	**Deductions from Reserves**	**Balance at End of Year**
Year Ended June 30, 2007	$ 2,958	$ (185)	$ 0	$ 125	$ 2,898
Year Ended June 30, 2006	$ 3,094	$ (153)	$ 0	$ (17)	$ 2,958
Year Ended June 30, 2005	$ 5,259	$ 69	$ 0	$ 2,234	$ 3,094

INDEX TO EXHIBITS

2.1	Asset Purchase Agreement, dated April 9, 2004, by and among Piedmont Mountainside Hospital, Inc., Piedmont Medical Center, Inc., Southern Health Corporation of Jasper, Inc., Southern Health Corporation, SunLink Healthcare Corp. and SunLink Health Systems, Inc. (incorporated by reference from Exhibit 2.1 of the Company s Report on Form 8-K dated April 14, 2004).
3.1	Amended Articles of Incorporation of SunLink Health Systems, Inc. (incorporated by reference from Exhibit 3.1 of the Company s Report on Form 10-Q for the quarter ended September 30, 2001).
3.2	Code of Regulations of SunLink Health Systems, Inc., as amended (incorporated by reference from Exhibit 3.2 of the Company s Report on Form 10-Q for the quarter ended September 30, 2001).
3.3	Certificate of Amendment to Amend Article Fourth of the Amended Articles of Incorporation of SunLink Health Systems, Inc. dated February 13, 2004 (incorporated by reference from Exhibit 3.1 of the Company s Report on Form 10-Q dated February 17, 2004).
4.1	Shareholder Rights Agreement dated as of February 8, 2004, between SunLink Health Systems, Inc. and Wachovia Bank, N.A., as Rights Agent (incorporated by reference from Exhibit 4.1 of the Company s Report on Form 8-K dated February 10, 2004).
10.1*	1995 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.3 of the Company s Report on Form 10-K for the year ended March 31, 1996).
10.2	Rent Review Memorandum between Rootmead Limited, Beldray Limited and KRUG International (UK) Limited dated August 30, 2000 (incorporated by reference from Exhibit 10.1 of the Company s Report on Form 10-Q dated September 30, 2001).
10.3	Counterpart/Reversionary Lease between Rootmead Limited, Beldray Limited and KRUG International (UK) Limited dated August 30, 2000 (incorporated by reference from Exhibit 10.2 of the Company s Report on Form 10-Q dated September 30, 2001).
10.4	Pre-emption Agreement between Rootmead Limited, Beldray Limited and KRUG International (UK) Limited dated August 30, 2000 (incorporated by reference from Exhibit 10.3 of the Company s Report on Form 10-Q dated September 30, 2001).
10.5	Lease between Barton Industrial Park Limited, Beldray Limited and Butterfield-Harvey Limited dated June 8, 1979 (incorporated by reference from Exhibit 10.4 of the Company s Report on Form 10-Q dated September 30, 2001).
10.6*	2001 Long-Term Stock Option Plan (incorporated by reference from Exhibit 10.5 of the Company s Report on Form 10-Q dated September 30, 2001).
10.7*	2001 Outside Directors Stock Ownership and Stock Option Plan (incorporated by reference from Exhibit 10.6 of the Company s Report on Form 10-Q dated September 30, 2001).
10.8	Agreement relating to the sale and purchase of the whole of the issued share capital of Beldray Limited dated 30 August, 2001, between Bradley International Holdings Limited and Marshall Cooper and John Clegg (incorporated by reference from Exhibit 10.1 of the Company s Report on Form 8-K dated October 15, 2001).

10.9	Variation relating to the sale and purchase of the whole of the issued share capital of Beldray Limited dated 30 August, 2001, dated 3 October, 2001, between Bradley International Holdings Limited and Marshall Cooper and John Clegg (incorporated by reference from Exhibit 10.2 of the Company s Report on Form 8-K dated October 15, 2001).
10.10*	Amended and Restated Employment Agreement between SunLink Health Systems, Inc. and J. T. Morris, dated February 1, 2002 (incorporated by reference from Exhibit 10.2 of SunLink s Form 10-Q for the quarter ended September 30, 2002).

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10.11*	Employment Letter, dated April 30, 2001, by and between SunLink Health Systems, Inc. and Mark Stockslager (incorporated by reference from Exhibit 10.29 of SunLink s Form 10-Q for the quarter ended September 30, 2005).
10.12*	Employment Letter, dated February 1, 2001, by and between SunLink Healthcare Corp. and Jerome Orth (incorporated by reference from Exhibit 10.30 of SunLink s Form 10-Q for the quarter ended September 30, 2005).
10.13	Credit Agreement between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.73 of the Company s Report on Form 8-K dated October 21, 2004).
10.14	Form of Revolving Note between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.74 of the Company s Report on Form 8-K dated October 21, 2004).
10.15	Form of Term Loan A Note between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.75 of the Company s Report on Form 8-K dated October 21, 2004).
10.16	Form of Term Loan B Note between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.76 of the Company s Report on Form 8-K dated October 21, 2004).
10.17	Form of Security Agreement between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.77 of the Company s Report on Form 8-K dated October 21, 2004).
10.18	Form of Pledge Agreement between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation dated October 15, 2004 (incorporated by reference from Exhibit 10.78 of the Company s Report on Form 8-K dated October 21, 2004).

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10.26	Form of Limited Consent Agreement, dated May 3, 2007, between SunLink Health Systems, Inc., SunLink Healthcare LLC, Dexter Hospital, LLC, Clanton Hospital, LLC, Southern Healthcare Corporation of Ellijay, Inc., Southern Health Corporation of Dahlonega, Inc., Southern Health Corporation of Houston, Inc., HealthMont, Inc., HealthMont of Georgia, Inc., HealthMont of Missouri, Inc., HealthMont, LLC, HealthMont of Missouri, LLC, SunLink Services, Inc., Optima Healthcare Corporation, and KRUG Properties, Inc., and Residential Funding Corporation, LLC.
10.27*	Employment Letter, dated September 30, 2002, by and between SunLink Healthcare Corp. and Jack M. Spurr, Jr.
21.1	List of Subsidiaries.
23.1	Consent of Cherry, Bekaert & Holland, L.L.P.
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.
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* Management contract or compensatory plan or arrangement.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders of

SunLink Health Systems, Inc.

We have audited the accompanying consolidated balance sheets of SunLink Health Systems, Inc. and subsidiaries (the Company) as of June 30, 2007 and 2006 and the related consolidated statements of operations, shareholder s equity, and cash flows for each of the three years in the period ended June 30, 2007. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company and subsidiaries as of June 30, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended June 30, 2007, in conformity with accounting principles generally accepted in the United States of America.

/s/ Cherry, Bekaert & Holland, L.L.P.

Atlanta, Georgia

September 21, 2007

SUNLINK HEALTH SYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS

JUNE 30, 2007 AND 2006

(All amounts in thousands)

	2007	2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 814	$ 1,084
Receivables net	14,537	16,494
Medical supplies	2,826	2,577
Deferred income tax asset	4,672	5,391
Prepaid expenses and other	2,930	2,363
Total current assets	25,779	27,909
PROPERTY, PLANT, AND EQUIPMENT At cost		
Land	2,256	2,256
Buildings and improvements	28,813	27,959
Equipment and fixtures	31,108	21,585
	62,177	51,800
Less accumulated depreciation	14,854	10,645
Property, plant, and equipment net	47,323	41,155
NONCURRENT ASSETS:		
Goodwill	2,944	2,944
Pension asset	216	505
Other noncurrent assets	1,581	1,790
Total noncurrent assets	4,741	5,239
TOTAL ASSETS	$ 77,843	$ 74,303
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 8,512	$ 7,689
Revolving advances	4,700	
Third-party payor settlements	3,668	3,666
Current maturities of long-term debt	875	928
Accrued payroll and related taxes	4,748	5,231
Income taxes	82	211
Current liabilities of Mountainside Medical Center	599	1,528
Accrued employee medical claims	596	51
Other accrued expenses	2,875	2,991
Total current liabilities	26,655	22,295
LONG-TERM LIABILITIES:		
Long-term debt	7,661	8,465
Noncurrent deferred income tax liabilities	2,927	4,025

Noncurrent liability for professional liability risks	2,415	3,281
Other noncurrent liabilities	2,161	1,885
Total long-term liabilities	15,164	17,656
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		
Preferred Shares, authorized and unissued, 2,000 shares		
Common Shares, no par value; authorized, 12,000 shares; issued and outstanding, 7,510, shares at June 30, 2007 and 7,315 shares at June 30, 2006	3,755	3,658
Additional paid-in capital	8,904	8,393
Retained earnings	23,941	22,545
Accumulated other comprehensive loss	(576)	(244)
Total shareholders equity	36,024	34,352
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 77,843	$ 74,303

See notes to consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF EARNINGS

FOR THE YEARS ENDED JUNE 30, 2007, 2006 AND 2005

(All amounts in thousands, except per share amounts)

		Years Ended	
	June 30, 2007	June 30, 2006	June 30, 2005
Net revenues	$ 143,645	$ 135,576	$ 128,732
Cost of Patient Service Revenues:			
Salaries, wages and benefits	70,475	67,037	62,080
Provision for bad debts	19,580	14,987	11,979
Supplies	15,479	14,275	14,220
Purchased services	9,081	8,687	7,703
Other operating expenses	17,424	17,111	20,241
Rents and leases expense	2,792	2,452	2,829
Depreciation and amortization	4,400	3,400	2,590
	139,231	127,949	121,642
Operating profit	4,414	7,627	7,090
Other income (expense):			
Interest expense	(1,462)	(1,146)	(1,110)
Interest income	69	75	42
Loss on early repayment of debt			(384)
Earnings from continuing operations before income taxes	3,021	6,556	5,638
Income tax expense	1,444	2,375	1,255
Earnings from continuing operations	1,577	4,181	4,383
Earnings (loss) from discontinued operations, net of income taxes	(181)	(272)	157
Net earnings	$ 1,396	$ 3,909	$ 4,540
Earnings per share:			
Continuing operations:			
Basic	$ 0.21	$ 0.58	$ 0.61
Diluted	$ 0.20	$ 0.53	$ 0.57
Discontinued operations:			
Basic	$ (0.02)	$ (0.04)	$ 0.02
Diluted	$ (0.02)	$ (0.03)	$ 0.02
Net earnings:			
Basic	$ 0.19	$ 0.54	$ 0.63
Diluted	$ 0.18	$ 0.50	$ 0.59
Weighted-average common shares outstanding:			

Basic	7,397	7,258	7,166
Diluted	7,810	7,858	7,711

See notes to consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

FOR THE YEARS ENDED JUNE 30, 2007, 2006 AND 2005

(All amounts in thousands)

	Common Shares					Accumulated	
	Shares	Amount	Additional Paid-in Capital	Retained Earnings	Common Share Warrants	Other Comprehensive Income (Loss)	Total Shareholders Equity
JUNE 30, 2004	7,072	3,536	7,400	14,145	230	(407)	24,904
Net earnings				4,540			4,540
Foreign currency translation adjustment						25	25
Minimum pension liability adjustment, net of tax of $73						(141)	(141)
Total comprehensive income							4,424
Common share warrants repurchased				(49)	(60)		(109)
Common shares issued	126	63	189		(170)		82
JUNE 30, 2005	7,198	3,599	7,589	18,636	0	(523)	29,301
Net earnings				3,909			3,909
Foreign currency translation adjustment						(59)	(59)
Minimum pension liability adjustment, net of tax of $174						338	338
Total comprehensive income							4,188
Share-based compensation			577				577
Common shares issued including tax benefits	117	59	227				286
JUNE 30, 2006	7,315	3,658	8,393	22,545	0	(244)	34,352
Net earnings				1,396			1,396
Foreign currency translation adjustment						(95)	(95)
Minimum pension liability adjustment, net of tax of $143						(237)	(237)
Total comprehensive income							1,064
Share-based compensation			353				353
Common shares issued, including tax benefits	195	97	158				255
JUNE 30, 2007	7,510	$ 3,755	$ 8,904	$ 23,941	$ 0	$ (576)	$ 36,024

See notes to consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED JUNE 30, 2007, 2006 AND 2005

(All amounts in thousands)

	Years Ended		
	June 30, 2007	**June 30, 2006**	**June 30, 2005**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net earnings	$ 1,396	$ 3,909	$ 4,540
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:			
Depreciation and amortization	4,400	3,400	2,590
Stock-based compensation	362	633	
Repurchase of share warrant			(109)
Deferred income taxes	(379)	(155)	(189)
Non cash loss on early repayment of debt			263
Change in assets and liabilities:			
Receivables	1,958	(1,946)	(2,181)
Medical supplies	(249)	(227)	(110)
Prepaid expenses and other assets	(498)	(1,136)	(1,023)
Accounts payable and accrued expenses	(1,267)	350	1,643
Income taxes	(178)	(885)	(3,092)
Third-party payor settlements	148	(68)	(663)
Net cash provided by (used in) discontinued operations	(944)	631	556
Net cash provided by operating activities	4,749	4,506	2,225
CASH FLOWS FROM INVESTING ACTIVITIES:			
Expenditures for property, plant, and equipment	(9,037)	(8,012)	(4,029)
Net cash used in investing activities	(9,037)	(8,012)	(4,029)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common shares	246	231	82
Additions to long-term debt- continuing operations			10,000
Payment of long-term debt continuing operations	(928)	(922)	(7,486)
Revolving advances, net	4,700		(2,591)
Net cash provided by (used in) financing activities	4,018	(691)	5
EFFECT OF EXCHANGE RATE CHANGES ON CASH			1
NET DECREASE IN CASH AND CASH EQUIVALENTS	(270)	(4,197)	(1,798)
CASH AND CASH EQUIVALENTS:			
Beginning of year	1,084	5,281	7,079
End of year	$ 814	$ 1,084	$ 5,281
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid for:			
Income taxes	$ 1,725	$ 3,273	$ 4,752

Interest, net of amounts capitalized	$ 1,423	$ 1,136	$ 1,040
Noncash investing and financing activities			
Assets acquired under capital lease obligations	$ 72	$ 272	$ 0
Property, plant and equipment acquired but not yet paid	$ 1,382	$ 0	$ 0

See notes to consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

AS OF AND FOR THE YEARS ENDED JUNE 30, 2007, 2006 AND 2005

(All amounts in thousands, except share and per share amounts)

1. BUSINESS OPERATIONS AND CORPORATE STRATEGY

SunLink Health Systems, Inc. (SunLink , we , our , ours , us or the Company) is a provider of healthcare services through the operation of 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 fiscal year ended June 30, 2007, SunLink concentrated its efforts on the operation and improvement of its existing hospitals. During the current fiscal year, SunLink has evaluated certain hospitals which were for sale and monitored selected hospitals which SunLink has determined might become available for sale. SunLink continues to engage in similar evaluation and monitoring activities with respect to hospitals which are or may become available for acquisition.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation The consolidated financial statements include the accounts of SunLink and its domestic and foreign subsidiaries, all of which are 100% owned. All significant intercompany transactions and balances have been eliminated.

Management Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates made by management involve reserves for adjustments to net patient service revenues, evaluation of the recoverability of assets, including accounts receivable, and the assessment of litigation and contingencies, including income taxes and related tax asset valuation allowances, all as discussed in more detail in the remainder of these notes to the consolidated financial statements. Actual results could differ materially from these estimates.

Net Patient Service Revenue SunLink has agreements with third-party payors that provide for payments at amounts different from established charges. Payment arrangements vary and include prospectively determined rates per discharge, reimbursed costs, discounted charges and per diem payments. Patient service revenues are reported as services are rendered at the estimated net realizable amounts from patients, third-party payors, and

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

others. Estimated net realizable amounts are estimated based upon contracts with third-party payors, published reimbursement rates, and historical reimbursement percentages pertaining to each payor type. Estimated reductions in revenues to reflect agreements with third-party payors and estimated retroactive adjustments under such reimbursement agreements are accrued during the period the related services are rendered and are adjusted in future periods as interim and final settlements are determined. Significant changes in reimbursement levels for services under government and private programs could significantly impact the estimates used to accrue such revenue deductions. At June 30, 2007, there were no material claims or disputes with third-party payors.

Charity Care SunLink provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because SunLink does not pursue collection of amounts determined to qualify as charity, they are not reported as revenue. SunLink provided $5,062, $2,992, and $2,600 of charity care in the fiscal years ended June 30, 2007, 2006 and 2005, respectively.

Concentrations of Credit Risk SunLink grants unsecured credit to its patients, most of who reside in the service area of SunLink s facilities and are insured under third-party agreements. Because of the geographic diversity of SunLink s facilities and nongovernmental third-party payors, Medicare and Medicaid accounts represent SunLink s only significant concentrations of credit risk. Medicare net revenues were approximately 46% of net revenues for the years ended June 30, 2007, 2006, and 2005. Medicaid was approximately 15%, 16%, and 17% of net revenues for the years ended June 30, 2007, 2006, and 2005, respectively. Medicare receivables were approximately 33% of receivable net at June 30, 2007 while Medicaid receivables were approximately 17% of receivable-net at the same date.

Cash and Cash Equivalents Cash and cash equivalents consist of highly liquid financial instruments, which have original maturities of three months or less. Cash is deposited with commercial banks and may have deposits totaling amounts in excess of the Federally insured limits from time to time.

Medical Supplies Medical supplies are valued at the lower of cost or market, using the first-in, first-out method.

Allowance for Doubtful Accounts Substantially all of SunLink s receivables result from providing healthcare services to hospital facility patients. Accounts receivable are reduced by an allowance for doubtful accounts estimated to become uncollectible in the future. The Company calculates an allowance percentage based generally upon its historical collection experience for each type of payor. The allowance amount is computed by applying allowance percentages to receivable amounts included in specific payor categories. Significant changes in reimbursement levels for services under government and private programs could significantly impact the estimates used to determine the allowance for doubtful accounts. Accounts receivable are written off after all collection efforts have failed, normally within six months of billing.

Property, Plant, and Equipment Property, plant, and equipment, including capital leases, are recorded at cost. Depreciation is recognized over the estimated useful lives of the assets, which range from 5 to 45 years, on a straight-line basis. Generally, furniture and fixtures are depreciated over 5 to 10 years, machinery and equipment over 10 years, and buildings over 25 to 45 years. Leasehold improvements and leased machinery and equipment are depreciated over the lease term or estimated useful life, whichever is shorter, of the asset and range from 5 to 15 years. Expenditures for major renewals and replacements are capitalized. Expenditures for maintenance and repairs are charged to operating expense as incurred. When property items are retired or otherwise disposed of, amounts applicable to such items are removed from the related asset and accumulated depreciation accounts and any resulting gain or loss is credited or charged to income. Depreciation expense totaled $4,279, $3,373, and $2,533 for the years ended June 30, 2007, 2006 and 2005, respectively.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Risk Management SunLink is exposed to various risks of loss from medical malpractice and other claims and casualties; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters (including earthquakes); and employee health, dental and accident benefits. Commercial insurance coverage is purchased for a portion of claims arising from such matters. When, in management s judgment, claims are sufficiently identified, a liability is accrued for estimated costs and losses under such claims, net of estimated insurance recoveries.

By virtue of the acquisition of its initial six hospitals, SunLink assumed responsibility for professional liability claims reported after the February 1, 2001 acquisition date and the previous owner retained responsibility for all known and filed claims prior to the acquisition date. SunLink purchased claims-made commercial insurance for acts prior to and after the acquisition date. The recorded liability for professional liability risks includes an estimate of the liability for claims incurred prior to February 1, 2001, but reported after February 1, 2001, and for claims incurred after February 1, 2001. These amounts are based on actuarially determined amounts.

In connection with the acquisition of HealthMont and its two hospitals, SunLink assumed responsibility for all professional liability claims. HealthMont had purchased claims-made commercial insurance for claims made prior to the acquisition and SunLink purchased claims-made commercial insurance for claims made after the acquisition. The recorded liability for professional liability risks includes an estimate of liability for claims assumed at the acquisition and for claims incurred after the acquisition. These amounts are based on actuarially determined amounts.

The Company self-insures for workers compensation risk. The estimated liability for workers compensation risk includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. The Company was self-insured for employee health risks until October 1, 2005 when a fully-insured employee health insurance plan was entered into.

The Company accrues an estimate of losses resulting from workers compensation and professional liability claims to the extent they are not covered by insurance. These accruals are estimated quarterly based upon management s review of claims reported and historical loss data.

The Company records a liability pertaining to pending litigation if it is probable a loss has been incurred and accrues the most likely amount of loss based on the information available. If no amount within the range of losses estimated from the information available is more likely than any other amount in the range of loss, the minimum amount in the range of loss is accrued. Because of uncertainties surrounding the nature of litigation and the ultimate liability to SunLink, if any, we revise estimated losses as additional facts become known.

Long-lived Assets SunLink periodically assesses the recoverability of assets based on its expectations of future profitability and the undiscounted cash flows of the related operations and, when circumstances dictate, adjusts the carrying value of the asset to estimated fair value. These factors, along with management s plans with respect to the operations, are considered in assessing the recoverability of long-lived assets.

Goodwill SunLink accounts for goodwill from business combinations in accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* . Goodwill represents the cost of acquired businesses in excess of fair value of identifiable tangible and intangible net assets purchased. SFAS No. 142 recognizes that goodwill has an indefinite life and is not subject to periodic amortization. However, goodwill is tested at least annually for impairment, using a fair value methodology, in lieu of amortization. Definite-life intangible assets, such as certificates of need, are amortized on a straight-line

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

basis over their estimated useful lives, generally for periods ranging from 23 to 30 years. SunLink evaluates the reasonableness of the useful lives of intangible assets and they are tested for impairment as conditions warrant according to SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Amortization expense related to intangible assets is estimated to be $170 in 2008, $163 in 2009, $83 in 2010, and $27 in 2011 and 2012. Intangible assets, net of accumulated amortization of $75 and $195, included in other noncurrent assets were $863 and $555 at June 30, 2007 and 2006, respectively.

Income Taxes SunLink accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. SFAS No. 109 requires an asset and liability approach and the recognition of deferred tax assets and liabilities for expected future tax consequences. SFAS No. 109 generally requires consideration of all expected future events other than proposed enactments of changes in the income tax law or rates. When management determines, using factors identified in SFAS No. 109, that it is more likely than not that a portion of or none of the net deferred tax asset will be realized through future taxable earnings or implementation of tax planning strategies, management provides a valuation allowance for the portion not expected to be realized.

Share-Based Compensation The Company issues common share options to key employees and directors under various shareholder-approved plans. Prior to July 1, 2005, the Company accounted for its share-based employee compensation under the measurement and recognition provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* and related Interpretations, as permitted by SFAS No. 123 *Accounting for Stock-Based Compensation*. The Company did not record any share-based employee compensation expense for options granted under its option plans prior to July 1, 2005, as all options granted under these plans had exercise prices equal to the fair market value of the Company s common shares on the date of grant. Effective July 1, 2005, the Company adopted SFAS No. 123 (R) *Share-Based Payment*, using the modified prospective transition method. Under that transition method, compensation expense that the Company recognizes beginning on July 1, 2005, includes: (i) compensation expense for all share options granted prior to, but not yet vested as of, July 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123; and (ii) compensation expense for share options granted on or after July 1, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Results for prior periods are not required nor have they been restated for the adoption of SFAS No. 123(R). Share-based compensation expense of $353 and $577 for the fiscal years ended June 30, 2007 and 2006, respectively, was recorded in salaries, wages and benefits expense for share options issued to employees and directors of the Company in accordance with SFAS No. 123(R). The fair value of the share options was estimated using the Black-Scholes option pricing model. The historical volatility is used to calculate the estimated volatility in this model.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Prior to July 1, 2005, the Company accounted for share-based compensation expense under the provisions of APB No. 25. Accordingly, the Company did not record share-based compensation expense for its share options prior to the year ended June 30, 2006. Pro forma net earnings and net earnings per share amounts that would have resulted had compensation expense for share options been determined using the fair value-based method is as follows:

	Year Ended June 30, 2005
Net Earnings	$ 4,540
Deduct: Total stock-based compensation expense determined under the fair value based method for all awards	313
Pro forma net earnings	$ 4,227
Net earnings per share	
Basic as reported	$ 0.63
Basic pro forma	0.59
Diluted as reported	0.59
Diluted pro forma	$ 0.55

Fair Value of Financial Instruments The recorded values of cash, receivables, and payables approximate their fair values because of the relatively short maturity of these instruments. Similarly, the fair value of SunLink s long-term debt is estimated to approximate its recorded values due to its relatively short maturity period 3 years.

Earnings (Loss) per Share Earnings (loss) per common share is based on the weighted-average number of common shares and dilutive common share equivalents outstanding for each period presented, including vested and unvested shares issued under SunLink s 1995 Incentive Stock Option Plan, 2001 Long-Term Stock Option Plan, 2001 Outside Directors Stock Ownership and Stock Option Plan, 2005 Equity Incentive Plan and outstanding share purchase warrants issued by SunLink. Common share equivalents represent the dilutive effect of the assumed exercise of the outstanding stock options and warrants.

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

agreement, which is typically two to three years. The expense recorded for physician guarantees accounted for under FSP FIN 45-3 during the fiscal years ended June 30, 2007 and 2006 was $629 and $41 less than would have been expensed using the Company s previous accounting policy.

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

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

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

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

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements Nos. 87, 88, 106, and 132(R), which requires a business entity to recognize the overfunded or underfunded status of a single-employer defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in comprehensive income in the year in which the changes occur. SFAS No. 158 also requires a business entity to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The Company adopted SFAS 158 at the end of the fiscal year ended June 30, 2007 with no effect on the consolidated statement of earnings. The pension asset recognized in the consolidated balance sheet at June 30, 2007 was reduced by $380, the amount of the unrecognized actuarial loss for that date as determined under FASB Statement No. 87. An offsetting $380 pre-tax amount was recorded in shareholders equity in accumulated other comprehensive loss.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

In September 2006, the U.S. Securities and Exchange Commission (SEC) staff added Section N to Staff Accounting Bulletin (SAB) Topic 1 through the issuance of SAB 108 Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements). SAB 108 addresses how a company should evaluate whether an error in its financial statements is material. The guidance in SAB 108 will be effective for annual financial statements with fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our consolidated results of operations or our consolidated financial position.

Reclassifications Certain amounts in prior periods consolidated financial statements have been reclassified to conform to the current period s presentation.

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.

Mountainside Medical Center On June 1, 2004, SunLink completed the sale of its Mountainside Medical Center (Mountainside) hospital in Jasper, Georgia, for approximately $40,000 pursuant to the terms of an asset sale agreement. Under the terms of the agreement, SunLink sold the operations of Mountainside, which included substantially all the property, plant and equipment and the supplies inventory. SunLink retained Mountainside s working capital except for supplies inventory. The retained liabilities of Mountainside are shown in current liabilities of Mountainside Medical Center on the consolidated balance sheet. The pre-tax losses for the fiscal year ended June 30, 2007 resulted primarily from legal expenses related to a claim made by the buyer of Mountainside and a counterclaim made by SunLink. See the Litigation section in Note 10 Commitments and Contingencies which follows for additional disclosure of the claims. The legal expenses were offset for the fiscal year ended June 30, 2007 by $189 of favorable settlements of prior year Medicaid cost reports relating to periods prior to SunLink s sale of Mountainside.

Life Sciences and Engineering Segment SunLink retained a defined benefit retirement plan which covered substantially all of the employees of this segment when it was sold in fiscal 1998. Effective February 28, 1997, the plan was amended to freeze participant benefits and close the plan to new participants. Pension expense and related tax benefit or expense is reflected in the results of operations for this segment for the fiscal years ended June 30, 2007, 2006 and 2005.

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 location. 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

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

On August 6, 2007, the liquidator of KRUG UK made an application in The Birmingham County Court in Birmingham, England, in which the liquidator is seeking a declaration by the court that certain transactions in 2001 from KRUG UK to SunLink in connection with the purchase of certain preferred stock of another subsidiary of SunLink and the making of a loan to SunLink, and certain deductions to debt owed to SunLink by KRUG UK were improper because KRUG UK was then effectively insolvent and the approval of such transactions by the then directors of KRUG UK resulted in a breach of their fiduciary duties. The liquidator seeks to have the court order the former directors or, in the alternative, the Company, to account for, or reverse such transactions to the liquidator of KRUG UK. A hearing on this application is set for October 2007. In connection with the allegations in the application of breach of fiduciary duty by the directors of KRUG UK in approving such transactions, SunLink has indemnification obligations to the former directors of KRUG UK. SunLink denies any liability to Krug UK other than to it in its status as a preferred stockholder and for the unpaid balance on the promissory note. SunLink, through its United Kingdom counsel, intends to vigorously defend against the liquidator s claims. See the Litigation section in Note 10 Commitments and Contingencies which follows for additional disclosure of the application.

SunLink s non-current liability reserves for discontinued operations at June 30, 2007, included a reserve for a portion of the Beldray Guarantee, which would include the Application made by the liquidator of KRUG UK in August 2007. 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 18 years SunLink has discontinued operations carried on by its former Mountainside Medical Center and its former industrial, U.K. leisure marine, life sciences and engineering, and European child safety segments, as well as the U.K. housewares segment. SunLink s reserves relating to discontinued operations of these segments represent management s best estimate of SunLink s possible liability for property, product liability and other claims for which SunLink may incur liability. These estimates are based on management s judgments, using currently available information, as well as, in certain instances, consultation with its insurance carriers, third party advisors and legal counsel. While estimates have been based on the evaluation of available information, it is not possible to predict with certainty the ultimate outcome of many contingencies relating to discontinued operations. SunLink intends to continue to adjust its estimates of the reserves as additional information is developed and evaluated. However, management believes that the final resolution of these contingencies will not have a material adverse impact on the financial position, cash flows or results of operations of SunLink.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of the loss reserves for discontinued operations:

	Years Ended June 30,		
	2007	**2006**	**2005**
Beginning balance	$ 1,301	$ 1,298	$ 1,479
Usage	(17)	(32)	(155)
Exchange differences	112	35	(26)
	$ 1,396	$ 1,301	$ 1,298

Results of discontinued operations were as follows:

Discontinued Operations Summary Statement of Earnings Information

	Years Ended June 30,		
	2007	**2006**	**2005**
Earnings (loss) from discontinued operations:			
Mountainside Medical			
Earnings (loss) from operations	$ (171)	$ (564)	$ 346
Income tax expense (benefit)	(68)	(174)	70
Earnings (loss) from Mountainside Medical Center after income taxes	(103)	(390)	276
Life sciences and engineering segment:			
Loss from operations before income taxes	(129)	(56)	(46)
Income tax expense (benefit)	(51)	(174)	73
Earnings (loss) from life sciences and engineering segment after income taxes	(78)	118	(119)
Earnings (loss) from discontinued operations	$ (181)	$ (272)	$ 157

4. NET REVENUES AND RECEIVABLES

SunLink has agreements with third-party payors that provide for payments at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

Medicare Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per Diagnosis Related Group. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Inpatient nonacute services, certain outpatient services, and defined capital and medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. Cost reimbursable items are paid at a tentative rate, with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary.

Medicaid Inpatient and outpatient services rendered to Medicaid program beneficiaries are reimbursed either under contracted rates or reimbursed for cost reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports and audits thereof by the Medicaid fiscal intermediary.

SunLink also has entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Summary information for receivables is as follows:

	June 30, 2007	June 30, 2006
Patient accounts receivable (net of contractual allowances)	$ 24,734	$ 25,425
Less allowance for doubtful accounts	(10,197)	(8,931)
Patient accounts receivable (net of allowances)	$ 14,537	$ 16,494

Net revenues included $266, $312, and $707 for the years ended June 30, 2007, 2006 and 2005, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

5. LONG-TERM DEBT

Long-term debt consisted of the following:

	June 30, 2007	June 30, 2006
SunLink Term Loan	$ 8,222	$ 8,889
Capital lease obligations	314	504
Total	8,536	9,393
Less current maturities	(875)	(928)
	$ 7,661	$ 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% (8.23% at 6/30/07), a $10,000 term loan (SunLink Term Loan A) with an interest rate at LIBOR plus 3.91% (9.23% at 6/30/07) 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 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 June 30, 2007 of approximately $28,222. Debt outstanding under the facility as of the fiscal year end June 30, 2007 was the SunLink Term Loan A of $8,222 and $4,700 of the revolving line of credit. SunLink may use the remaining funds from the initial draw and the funds available from the revolving line of credit for hospital capital projects and equipment purchases and for working capital needs. The Company began using the revolving line of credit during July 2006. Borrowing under the $5,000 SunLink Term Loan B may be used, subject to satisfaction of certain covenants, to satisfy certain claims or obligations with respect to discontinued operations, 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.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Annual required payments of debt for the next five years and thereafter are as follows:

2008	875
2009	757
2010	6,904
2011	
2012	
2013 and thereafter	
Total	$ 8,536

The contractual commitments for interest on long-term debt are shown in the following table. The interest rate on variable interest debt is calculated at the interest rate at June 30, 2007.

2008	748
2009	681
2010	156
2011	
2012	
2013 and thereafter	
Total	$ 1,585

6. LOSS ON EARLY REPAYMENT OF DEBT

In October 2004, the Company repaid, from proceeds of the SunLink Credit Facility, mortgages (principal amounts of $6,325) due August 2005 and a revolving loan ($1,289 outstanding at payment date) which had an expiration date of August 31, 2005. The early repayment resulted in a loss on early repayment of debt of $384. This loss is composed of $263 of unamortized prepaid debt costs related to the repaid debt instruments and a $121 penalty related to the early repayment of the revolving loan.

7. SHAREHOLDERS EQUITY

Employee and Directors Stock Option Plans On November 7, 2005, the 2005 Equity Incentive Plan was approved by SunLink s shareholders at the Annual Meeting of Shareholders. This Plan permits the grant of options to employees, non-employee directors and service providers of SunLink for the purchase of up to 800,000 common shares by November 2015. This Plan restricts the number of Incentive Stock Options to 700,000 shares and Restricted Stock Awards to 200,000 shares. The combination of Incentive Stock Options and Restricted Stock Awards cannot exceed 800,000 shares. Each award of Restricted Shares reduces the number of share options to be granted by four option shares for each Restricted Share awarded. No options have been exercised under this plan. Options outstanding under this Plan were 241,906 and 237,200 at

June 30, 2007 and 2006, respectively.

On August 20, 2001, the 2001 Outside Directors Stock Ownership and Stock Option Plan was approved by SunLink s shareholders at the Annual Meeting of Shareholders. This Plan permitted the grant of options to outside directors of SunLink for the purchase of up to 90,000 common shares through March 2006. Options for 90,000 shares were granted by March 2006 and 82,500 options were outstanding at June 30, 2007. Options for 7,500 shares have been exercised under this plan. Options outstanding under this Plan were 82,500 at both June 30, 2006 and 2005, respectively.

On February 28, 2001, the 2001 Long-Term Stock Option Plan was approved by the Board of Directors of SunLink. The 2001 Long-Term Stock Option Plan permitted the grant of options to officers and other key

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

employees for the purchase of up to 810,000 common shares through February 2006. Options for 413,625 shares were outstanding at June 30, 2007. Options totaling 213,234 shares under this plan have been exercised. Options outstanding under this Plan were 634,150 and 744,400 at June 30, 2006 and 2005, respectively.

SunLink s 1995 Incentive Stock Option Plan permitted the grant of options to officers and key employees to purchase up to 250,000 common shares through May 2005. Vesting and option expiration periods for options granted are determined by the Board of Directors but may not exceed 10 years. Options for 246,000 shares have been exercised and options for 4,000 shares were outstanding at June 30, 2007. Options outstanding under this Plan were 4,000 and 10,000 at June 30, 2006 and 2005, respectively.

The activity of Company s shares options is shown in the following table:

	Number of Shares	Weighted-Average Exercise Price	Range of Exercise Prices
Options outstanding June 30, 2004	800,100	$ 1.87	$ 1.25 $5.50
Granted	104,250	6.49	5.48 8.95
Exercised	(50,550)	1.61	1.25 4.00
Forfeited	(16,900)	2.96	2.50 5.48
Options outstanding June 30, 2005	836,900	2.44	1.50 8.95
Granted	254,500	9.64	8.15 10.24
Exercised	(117,625)	1.97	1.50 5.50
Forfeited	(15,925)	8.45	3.00 9.63
Options outstanding June 30, 2006	957,850	4.31	1.50 8.95
Granted	55,000	6.79	6.55 7.15
Exercised	(213,234)	1.75	1.50 6.57
Forfeited	(57,585)	8.93	2.80 9.63
Options outstanding June 30, 2007	742,031	$ 4.82	$ 1.50 $10.24
Options exercisable, June 30, 2005	664,446	$ 1.75	$ 1.50 $5.50
Options exercisable, June 30, 2006	623,618	$ 2.05	$ 1.50 $6.57
Options exercisable, June 30, 2007	569,227	$ 3.67	$ 1.50 $10.24

The weighted-average fair value of each option granted during the years ended June 30, 2007, 2006, and 2005 was $2.14, $4.01, and $3.00, respectively. The fair value of each stock option grant was estimated using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants during the years ended June 30, 2007, 2006 and 2005, respectively: estimated volatility of 28%, 46%, and 50%; risk-free interest rate of 4.7%, 4.5%, and 6.2%; dividend yield of 0% for all years; and an expected life of 4.5 years, 4.0 years, and 4.0 years. The historical volatility is used to calculate the estimated volatility. The expected lives of the stock option grants were determined to be the midpoint between the vesting period and the contractual term of the grants. The estimate of the forfeited options in the compensation expense calculation was determined as the weighted-average forfeitures for the last three years. For the years ended June 30, 2007 and 2006, the Company recognized $353 and $577, respectively, of compensation expense for share options issued. Prior to the July 1, 2005 adoption of SFAS No. 123 (R), no compensation expense was recognized for the share option plans under the intrinsic value method of accounting for share option costs since the exercise price of the options was not less than the fair value of SunLink s common shares at the grant date. As of June 30, 2007, there was $230 of unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Plans. That cost is expected to be recognized over a weighted average period of 1.28 years. See Note 2 Summary of Significant Accounting Policies Recent Accounting Standards for further discussion of SFAS No. 123 (R).

Information with respect to stock options outstanding and exercisable at June 30, 2007 is as follows:

Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life (in years)	Number Exercisable
$ 1.50	277,500	1.95	277,500
$ 2.50	25,000	3.49	25,000
$ 2.65	12,000	3.69	9,000
$ 2.80	2,000	4.86	1,125
$ 2.90	37,500	6.45	37,500
$ 2.91	25,500	2.38	25,500
$ 3.00	16,625	2.66	16,625
$ 3.82	750	5.69	
$ 4.00	5,000	3.60	5,000
$ 5.48	5,750	2.98	2,876
$ 6.39	6,000	2.72	4,000
$ 6.55	33,000	8.24	33,000
$ 6.57	80,000	2.64	53,336
$ 7.15	18,000	4.65	
$ 8.15	500	3.20	125
$ 9.63	190,906	4.23	77,140
$ 9.95	4,000	3.36	1,000
$10.24	2,000	3.46	500
	742,031	3.34	569,227

The total intrinsic value of options exercised during the years ended June 30, 2007, 2006 and 2005 were $976, $933, and $654, respectively. As of June 30, 2007, the aggregate intrinsic value of options outstanding and shares exercisable were $1,773 and $1,754, respectively.

Warrants SunLink issued 999,487 warrants to shareholders of record on December 23, 1995. For each five common shares held, SunLink distributed one warrant for the purchase of one common share. The warrants entitled the holders to purchase common shares for $8.625 per share through their extended expiration date of January 31, 2007. SunLink had the ability to reduce the purchase price at any time. On November 19, 2003, the Company reduced the warrant exercise price to $2.50 per share from November 20, 2003 to April 20, 2004. The reduced warrant exercise price of $2.50 was approximately 90% of the average closing price of common shares for the ten trading days prior to November 19, 2003. Common shares totaling 753,031 were purchased by warrant exercises through January 31, 2007 when the remaining outstanding warrants expired.

On March 23, 2003, in connection with a loan under which SunLink borrowed $700, SunLink issued a warrant exercisable for 17,500 common shares for a nominal exercise price of $0.01 per share. On October 3, 2003, in connection with the HealthMont Term Note under which SunLink borrowed $2,300 from the same lender, SunLink issued a warrant exercisable for 57,500 common shares for a nominal exercise price of $0.01 per share. Both warrants were exercised in December 2004 and 75,000 common shares were issued. On October 3,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2003, in connection with the HealthMont acquisition and assumption of certain HealthMont debt, SunLink issued a warrant exercisable for 26,723 common shares for a nominal exercise price of $0.01 per share. This warrant was repurchased by the Company in October 2004 for $100.

Shareholder Rights Plan On February 8, 2004, the Board of Directors of the Company declared a dividend of one Series A Voting Preferred Purchase Price Right (a Right) for each outstanding common share of the Company to record owners of common shares at the close of business on February 10, 2004. The Board of Directors declared these Rights to protect shareholders from coercive or otherwise unfair takeover tactics. The Rights should not interfere with any merger or other business combinations approved by the Board of Directors. The Rights expire on February 8, 2014 unless the Company redeems them at an earlier date. The Company may redeem the Rights in whole, but not in part, at a price of $0.001 per Right, at any time prior to a public announcement that a person has become an Acquiring Person.

Accumulated Other Comprehensive Income (Loss) Information with respect to the balances of each classification within accumulated other comprehensive income (loss) is as follows:

	Foreign Currency Translation Adjustment	Minimum Pension Liability Adjustment	Accumulated Other Comprehensive Income (Loss)
June 30, 2004	$ (210)	$ (197)	$ (407)
Current period change	25	(141)	(116)
June 30, 2005	(185)	(338)	(523)
Current period change	(59)	338	279
June 30, 2006	(244)		(244)
Current period change	(95)	(237)	(332)
June 30, 2007	$ (339)	$ (237)	$ (576)

8. INCOME TAXES

The provisions (benefits) for income taxes on continuing operations are as follows:

Year ended June 30,

	2007	2006	2005
Domestic:			
Current	$ 1,629	$ 2,522	$ 1,186
Deferred	(185)	(147)	69
Total income tax expense	$ 1,444	$ 2,375	$ 1,255

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred tax assets recorded in the balance sheets are as follows:

	June 30, 2007	June 30, 2006
Domestic:		
Net operating loss carryforward	$ 2,690	$ 2,770
Provision for loss on discontinued operations	61	61
Depreciation expense	(4,164)	(4,025)
Allowances for receivables	2,208	1,934
Accrued expenses	2,504	2,345
Pension liabilities	(81)	(46)
Other	137	(3)
	3,355	3,036
Less valuation allowance	(1,610)	(1,670)
Total domestic deferred tax assets	1,745	1,366
Foreign:		
Net operating loss carryforwards	111	111
Tax prepayments not currently utilized	840	840
Restructuring	337	337
	1,288	1,288
Less valuation allowance	(1,288)	(1,288)
Total foreign deferred tax assets	0	0
Net deferred tax assets	$ 1,745	$ 1,366

The differences between income taxes at the Federal statutory rate and the effective tax rate were as follows:

	Years Ended June 30, 2007	2006	2005
Income taxes at Federal statutory rate	$ 1,027	$ 2,229	$ 1,917
Changes in valuation allowance continuing operations	(54)	(136)	(914)
U.S. state income taxes	172	255	129
Share option expense	120	196	
Other	179	(169)	123
Total income tax expense (benefit) continuing operations	$ 1,444	$ 2,375	$ 1,255

The Company provided a $1,610 deferred tax valuation allowance for domestic assets as of June 30, 2007 so that the net domestic deferred tax assets were $1,745 as June 30, 2007. Based upon management s assessment, it is 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. Accordingly, the Company adjusted its valuation allowance to $1,610 representing that portion of the net domestic tax asset which may not be utilized. The Company had a deferred tax valuation allowance for the domestic tax asset at June 30, 2006 of $1,670 so that the net domestic assets at June 30, 2006 were $1,366. The domestic net operating loss carryforwards expire in 2021.

The Company provided a deferred tax valuation allowance for foreign tax assets as of June 30, 2007 and 2006, respectively, so that the net foreign deferred tax assets are $0. Based upon management s assessment, it is

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

more likely than not that none of its foreign deferred tax asset will be realized thorough future taxable earning or implementation of tax planning strategies. Usage of the foreign tax assets are considered less likely than not due to the current non-operating status of the Company s foreign subsidiaries.

9. EMPLOYEE BENEFITS

Defined Benefit Plans Prior to SunLink s acquisition of its initial hospitals, it historically maintained defined benefit retirement plans covering substantially all of its employees. No defined benefit plan is maintained for the community hospital segment employees. Benefits are based on years of service and level of earnings. SunLink funds the domestic plan, which is noncontributory, at a rate that meets or exceeds the minimum amounts required by the Employee Retirement Income Security Act of 1974.

Effective February 28, 1997, SunLink amended its domestic retirement plan to freeze participant benefits and close the plan to new participants. With the sale of SunLink s life sciences and engineering segment businesses in the fiscal year ended March 31, 1999, net domestic pension expense is now classified as an expense of discontinued operations. During the years ended June 30, 2007 and 2005, SunLink recognized curtailment losses of $76 and $27, respectively, for partial plan settlement of pension obligations to vested former employees.

At June 30, 2007, the plan s assets are invested 81% in cash and short term investments, 12% in equity investments and 7% in fixed income investments. The plan s current investment policy of primarily investing in cash and short term investments is in response to the poor returns on investment of the past 4 years in the equity markets, the returns available in the fixed income markets and the possible need for immediate liquidity as participants retire or withdraw from the plan. The expected return on investment of 4.0% is based upon the plan s historical return on assets. The plan expects to pay $62, $59, $56, $65 and $62 in pension benefits in the years ended June 30, 2007 though 2011, respectively. The plan expects to pay $357 in pension benefits for the years June 30, 2012 through 2016, in the aggregate. This assumes the plan participants elect to take monthly pension benefits as opposed to a lump sum payout when they reach age 65. The Company expects to make no contributions to the plan in the year ending June 30, 2008.

The components of net pension expense for all plans (comprised solely of a domestic plan), excluding the curtailment losses above, were as follows:

	Years Ended June 30,		
	2007	2006	2005
Service cost	$ 0	$ 0	$ 0
Interest cost	80	74	69
Expected return on assets	(54)	(49)	(66)
Amortization of prior service cost	27	31	15
Net pension expense	$ 53	$ 56	$ 18
Weighted-average assumptions:			
Discount rate	6.50%	5.75%	6.00%

Expected return on plan assets	4.00%	4.00%	6.50%
Rate of compensation increase	0.00%	0.00%	0.00%

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Summary information for the plans (comprised solely of a domestic plan) is as follows:

	June 30,	
	2007	**2006**
Change in Benefit Obligation		
Benefit obligation at the beginning of year	$ 1,249	$ 1,320
Service cost	$	$
Interest cost	80	74
Actuarial (gain) loss	5	(48)
Benefits paid	(258)	(97)
Adjustment in cost of settlement	32	
Benefit obligation at end of year	$ 1,108	$ 1,249
Change in Plan Assets		
Fair value of plan assets at beginning of year	$ 1,298	$ 1,169
Actual return on plan assets	64	26
Company contributions	220	200
Benefits paid	(258)	(97)
Fair value of plan assets at end of year	$ 1,324	$ 1,298
Funded status of the plans	216	49
Unrecognized actuarial loss	380	456
Prepaid benefit cost	$ 596	$ 505
Amounts Recognized in Consolidated Balance Sheets		
Prepaid benefit cost	$ 216	$ 505
Accumulated other comprehensive income*	380	
Net amount recognized	$ 596	$ 505

* Accumulated other comprehensive income represents pretax minimum pension liability adjustments.

Defined Contribution Plan In April 2001, SunLink adopted a defined contribution plan pursuant to IRS Section 401(k) covering substantially all domestic employees except for the employees of the two HealthMont hospitals. HealthMont had an existing 401(k) plan at the acquisition date which covered substantially all of the employees of the HealthMont hospitals. The HealthMont plan was merged into the SunLink plan in January 2005. SunLink matches a specified percentage of the employee s contribution as determined periodically by its management. No matching of HealthMont employees contribution was made prior to the merger of the HealthMont plan into the SunLink plan. Plan expense was $106, $462, and $427 for the years ended June 30, 2007, 2006 and 2005, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. COMMITMENTS AND CONTINGENCIES

Leases The Company leases various land, buildings, and equipment under operating lease obligations having noncancelable terms ranging from one to 14 years. Rent expense was $2,792, $2,452, and $2,829 for the years ended June 30, 2007, 2006 and 2005, respectively. Minimum lease commitments as of June 30, 2007 are as follows:

Fiscal year ending June 30:	
2008	$ 2,272
2009	1,815
2010	1,503
2011	776
2012	418
Thereafter	1,661
Total minimum lease payments	$ 8,445

Physician Guarantees At June 30, 2007 SunLink had contracts with five physicians which contain guaranteed minimum gross receipts. Physician guarantee contracts entered into after January 1, 2006 will be accounted for under the provisions of FSP FIN 45-3. See Note 2 Summary of Significant Accounting Policies Recent Accounting Standards 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 his/her practice within the hospital geographic area for a specific period (normally three years) or he/she 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 June 30, 2007 is a liability of $137 for physician guarantees accounted for under the provisions of FSP FIN 45-3. SunLink expensed $1,098, $1,699, and $2,259 for the fiscal years ended June 30, 2007, 2006 and 2005, respectively. Noncancelable commitments under these contracts as of June 30, 2007 are as follows:

Fiscal year ending June 30:	
2008	$ 348
2009	
2010	
2011	
2012	
Total	$ 348

Capital Commitments As of June 30, 2007, SunLink had approximately $1,382 in accounts payable for capital expenditures accepted prior to the quarter end. The Company has also begun a major renovation project at our Dahlonega, Georgia, facility which has an estimated cost of approximately $7,350, of which approximately

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$4,305 of cost has been paid or accrued to date and of which approximately $3,045 additional costs will be paid or accrued by the end of the current fiscal year. Except for the Dahlonega, Georgia major renovation, there are no other material future commitments for capital expenditures. In August 2007, the Company received final approval of a Certificate of Need application with the state of Georgia to build a replacement hospital in Ellijay, Georgia. To date SunLink has made no commitments related to the replacement hospital, however it has an option to purchase the land needed for the project which it expects to exercise in October 2007 at a cost of approximately $3,400.

Litigation The Company 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.

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

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

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

On August 6, 2007, the liquidator of KRUG UK made an application in The Birmingham County Court in Birmingham, England, in which the liquidator is seeking a declaration by the court that certain transactions in

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2001 from KRUG UK to SunLink in connection with the purchase of certain preferred stock of another subsidiary of SunLink and the making of a loan to SunLink, and certain deductions to debt owed to SunLink by KRUG UK were improper because KRUG UK was then effectively insolvent and the approval of such transactions by the then directors of KRUG UK resulted in a breach of their fiduciary duties. The liquidator seeks to have the court order the former directors or, in the alternative, the Company, to account for, or reverse such transactions to the liquidator of KRUG UK. A hearing on this application is set for October 2007. In connection with the allegations in the application of breach of fiduciary duty by the directors of KRUG UK in approving such transactions, SunLink has indemnification obligations to the former directors of KRUG UK. SunLink denies any liability to Krug UK other than to it in its status as a preferred stockholder and for the unpaid balance on the promissory note. SunLink, through its United Kingdom counsel, intends to vigorously defend against the liquidator s claims.

While the ultimate outcome and materiality of the Application cannot be determined, in management s opinion the Application will not have a material adverse effect on SunLink s financial condition or results of operations.

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

The health care industry is subject to numerous laws and regulations of Federal, state, and local governments. Compliance with these laws and regulations, specifically those relating to the Medicare and Medicaid programs, can be subject to government review and interpretation, as well as regulatory actions unknown and unasserted at this time. Recently, Government activity has increased with respect to investigations and allegations concerning possible violations of regulations by health care providers, which could result in the imposition of significant fines and penalties, as well as significant repayments of previously billed and collected revenues from patient services. Management believes that the Company is in substantial compliance with current laws and regulations.

The Health Insurance Portability and Accountability Act (HIPAA) was enacted on August 21, 1996 to assure health insurance portability, reduce healthcare fraud and abuse, guarantee security and privacy of health information and enforce standards for health information. Organizations are required to be in compliance with HIPAA provisions which have compliance dates beginning in April 2003 and ending in May 2007. Organizations are subject to significant fines and penalties if found not to be in compliance with HIPAA.

11. RELATED PARTIES

A director of the Company and the Company s secretary (who was a director of SunLink until November 2003 and is now director emeritus) are members of two different law firms, each of which provides services to SunLink. We have paid an aggregate of $624, $564, and $655 to these law firms in the fiscal years ended June 30, 2007, 2006 and 2005, respectively. Another director received $3 in the fiscal year ended June 30, 2005 as a fee for being a letter of credit obligor for up to $200 of SunLink s revolving credit loans assumed in the HealthMont acquisition. The letter of credit obligation expired in September 2004.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. EARNINGS PER SHARE
(Share Amounts in Thousands)

	Years Ended June 30, 2007		2006		2005	
	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
Earnings from continuing operations	$ 1,577		$ 4,181		$ 4,383	
Basic:						
Weighted-average shares outstanding	7,397	$ 0.21	7,258	$ 0.58	7,166	$ 0.61
Diluted:						
Weighted-average shares outstanding	7,810	$ 0.20	7,858	$ 0.53	7,711	$ 0.57
Earnings (loss) from discontinued operations	$ (181)		$ (272)		$ 157	
Basic:						
Weighted-average shares outstanding	7,397	$ (0.02)	7,258	$ (0.04)	7,166	$ 0.02
Diluted:						
Weighted-average shares outstanding	7,810	$ (0.02)	7,858	$ (0.03)	7,711	$ 0.02
Net Earnings	$ 1,396		$ 3,909		$ 4,540	
Basic:						
Weighted-average shares outstanding	7,397	$ 0.19	7,258	$ 0.54	7,166	$ 0.63
Diluted:						
Weighted-average shares outstanding	7,810	$ 0.18	7,858	$ 0.50	7,711	$ 0.59
Weighted -average number of shares outstanding basic	7,397		7,258		7,166	
Effect of dilutive director, employee and guarantor options and outstanding common share warrants	413		600		545	
Weighted-average number of shares outstanding diluted	7,810		7,858		7,711	

Share options of 197 for the year ended June 30, 2007 are not included in the computation of diluted earnings per share because their effect would be antidilutive. Share options of 25 for the year ended June 30, 2006 are not included in the computation of diluted earnings per share because their effect would be antidilutive. Share warrants of 246 for the years ended June 30, 2005 are not included in the computation of diluted earnings per share because their effect would be antidilutive.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)
(Share Amounts in Thousands)

The following selected quarterly data for the years ended June 30, 2007 and 2006, respectively, are unaudited.

		Fourth Quarter	Third Quarter	Second Quarter	First Quarter
NET REVENUE	YEAR ENDED JUNE 30, 2007	$ 37,596	$ 37,490	$ 34,076	$ 34,483
	YEAR ENDED JUNE 30, 2006	$ 34,805	$ 34,630	$ 32,242	$ 33,899
EARNINGS (LOSS) FROM CONTINUING OPERATIONS	YEAR ENDED JUNE 30, 2007	960	612	(463)	468
	YEAR ENDED JUNE 30, 2006	1,171	1,009	917	1,084
NET EARNINGS	YEAR ENDED JUNE 30, 2007	881	459	(494)	550
	YEAR ENDED JUNE 30, 2006	1,272	632	902	1,103
EARNINGS (LOSS) PER SHARE:					
Continuing operations					
Basic	YEAR ENDED JUNE 30, 2007	0.13	0.08	(0.06)	0.06
	YEAR ENDED JUNE 30, 2006	0.16	0.14	0.13	0.15
Diluted	YEAR ENDED JUNE 30, 2007	0.12	0.08	(0.06)	0.06
	YEAR ENDED JUNE 30, 2006	0.15	0.13	0.12	0.14
Net earnings (loss):					
Basic	YEAR ENDED JUNE 30, 2007	0.12	0.06	(0.07)	0.08
	YEAR ENDED JUNE 30, 2006	0.17	0.09	0.12	0.15
Diluted	YEAR ENDED JUNE 30, 2007	0.11	0.06	(0.07)	0.07
	YEAR ENDED JUNE 30, 2006	0.16	0.08	0.11	0.14
WEIGHTED-AVERAGE COMMON SHARESOUTSTANDING:					
Basic	YEAR ENDED JUNE 30, 2007	7,509	7,403	7,346	7,328
	YEAR ENDED JUNE 30, 2006	7,315	7,269	7,242	7,205
Diluted	YEAR ENDED JUNE 30, 2007	7,804	7,790	7,346	7,830
	YEAR ENDED JUNE 30, 2006	7,891	7,890	7,860	7,791