SUNLINK HEALTH SYSTEMS INC
Form 10-Q
February 12, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2009

OR

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

For the transition period from _________ to _________.

Commission File Number 1-12607

SUNLINK HEALTH SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Ohio	**31-0621189**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

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

(Address of principal executive offices)

(Zip Code)

(770) 933-7000

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter during the preceding 12 months (of for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

The number of Common Shares, without par value, outstanding as of February 11, 2010 was 8,049,682.

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

	December 31, 2009	June 30, 2009
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 1,206	$ 2,364
Receivables - net	18,176	21,116
Inventory	4,919	4,745
Income tax receivable	336	87
Deferred income tax asset	5,842	5,446
Prepaid expenses and other	3,636	3,265
Total Current Assets	34,115	37,023
Property, Plant and Equipment, at cost	72,781	71,557
Less accumulated depreciation and amortization	28,294	25,435
Property, Plant and Equipment - net	44,487	46,122
Intangible assets-net	12,165	12,587
Goodwill	9,024	9,453
Other assets	2,008	2,198
Total Assets	$ 101,799	$ 107,383
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 7,796	$ 9,131
Revolving advances	1,300	3,400
Current maturities of long-term debt	1,795	1,808
Current maturities of subordinated long-term debt	300	300
Accrued payroll and related taxes	5,135	4,749
Income taxes	616	1,664
Current liabilities of Mountainside Medical Center	594	594
Other accrued expenses	3,148	3,754
Total Current Liabilities	20,684	25,400
Long-Term Liabilities:		
Long-term debt	29,989	30,887
Subordinated long-term debt	2,400	2,550
Noncurrent liability for professional liability risks	3,152	3,072
Noncurrent deferred income tax liabilities	1,794	1,776
Other noncurrent liabilities	1,377	1,306
Total Long-term Liabilities	38,712	39,591
Commitments and Contingencies		
Shareholders Equity:		
Preferred shares, authorized and unissued, 2,000 shares		
Common shares, without par value:		
Issued and outstanding, 8,050 shares at December 31, 2009 and 8,050 shares at June 30, 2009	4,025	4,025
Additional paid-in capital	11,649	11,626

Retained earnings	26,435	26,463
Accumulated other comprehensive loss	(321)	(337)
Total Parent Company Shareholders Equity	41,788	41,777
Noncontrolling interest	615	615
Total Shareholders Equity	42,403	42,392
Total Liabilities and Shareholders Equity	$ 101,799	$ 107,383

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share amounts)

(unaudited)

	THREE MONTHS ENDED December 31,		SIX MONTHS ENDED December 31,	
	2009	2008	2009	2008
Net Revenues	$ 50,145	$ 49,758	$ 97,970	$ 96,436
Costs and Expenses				
Cost of goods sold	8,968	9,231	15,598	15,295
Salaries, wages and benefits	20,082	19,511	40,042	39,601
Provision for bad debts	6,305	5,987	13,123	11,732
Supplies	3,981	3,387	7,849	7,113
Purchased services	3,089	2,870	6,107	5,922
Other operating expenses	5,140	5,460	10,483	10,894
Rent and lease expense	808	776	1,628	1,560
Depreciation and amortization	1,695	1,699	3,357	3,404
Gain on sale of Home Health businesses			(2,342)	
Operating Profit	77	837	2,125	915
Other Income (Expense):				
Gain on sale of assets		180		180
Interest expense	(859)	(1,272)	(1,778)	(2,526)
Interest income	6	10	9	17
Earnings (Loss) from Continuing Operations before Income Taxes	(776)	(245)	356	(1,414)
Income Tax Expense (Benefit)	(365)	(84)	218	(650)
Earnings (Loss) from Continuing Operations	(411)	(161)	138	(764)
Loss from Discontinued Operations	(113)	(103)	(166)	(164)
Net Loss	$ (524)	$ (264)	$ (28)	$ (928)
Earnings (Loss) Per Share:				
Continuing Operations:				
Basic	$ (0.05)	$ (0.02)	$ 0.02	$ (0.10)
Diluted	$ (0.05)	$ (0.02)	$ 0.02	$ (0.10)
Discontinued Operations:				
Basic	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.02)
Diluted	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.02)
Net Loss:				
Basic	$ (0.07)	$ (0.03)	$ (0.00)	$ (0.12)
Diluted	$ (0.07)	$ (0.03)	$ (0.00)	$ (0.12)
Weighted-Average Common Shares Outstanding:				
Basic	8,050	7,990	8,050	7,963

Diluted	8,050	7,990	8,069	7,963

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	SIX MONTHS ENDED DECEMBER 31, 2009	2008
Net Cash Provided By (Used In) Operating Activities	$ 39	$ (788)
Cash Flows From Investing Activities:		
Proceeds from sale of Home Health businesses	3,300	
Expenditures for property, plant and equipment	(1,337)	(574)
Proceeds from sale of assets		522
Net Cash Provided by (Used in) Investing Activities	1,963	(52)
Cash Flows From Financing Activities:		
Revolving advances, net	(2,100)	1,600
Payments on long-term debt	(1,060)	(1,462)
Proceeds from issuance of common shares under stock option plans		108
Net Cash Provided by (Used in) Financing Activities	(3,160)	246
Net Decrease in Cash and Cash Equivalents	(1,158)	(594)
Cash and Cash Equivalents at Beginning of Period	2,364	1,716
Cash and Cash Equivalents at End of Period	$ 1,206	$ 1,122
Supplemental Disclosure of Cash Flow Information:		
Cash Paid For:		
Interest	$ 1,600	$ 1,734
Income taxes	$ 1,806	$ 820
Non-cash investing and financing activities:		
Assets acquired under capital lease obligation	$	$ 131

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

(all dollar amounts in thousands except per share amounts)

(unaudited)

Note 1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements as of and for the three and six month periods ended December 31, 2009 have been prepared in accordance with Rule 10-01 of Regulation S-X of the Securities and Exchange Commission (SEC) and, as such, do not include all information required by accounting principles generally accepted in the United States of America. These Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements included in the SunLink Health Systems, Inc. (SunLink , we , our , ours , us or the Company) Annual Report on Form 10-K for the fiscal year ended June 30, 2009, filed with the SE September 28, 2009. In the opinion of management, the Condensed Consolidated Financial Statements, which are unaudited, include all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position and results of operations for the periods indicated. The results of operations for the three month and six month periods ended December 31, 2009 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period.

Note 2. Business Operations and Corporate Strategy

Business Operations

SunLink Health Systems, Inc. is a provider of healthcare services in certain rural and exurban markets in the United States. SunLink s business is composed of two business segments:

- Healthcare Facilities, which consist of
  - Our seven community hospitals which have a total of 402 licensed beds;
  - Our three nursing homes, which have a total of 261 licensed beds, each of which is located adjacent to a corresponding SunLink community hospital; and
  - Our one home health agency, which operates in connection with a corresponding SunLink community hospital.
- Specialty Pharmacy, which consists of
  - Specialty pharmacy services;
  - Durable medical equipment;
  - Institutional pharmacy services; and

Retail pharmacy products and services, all of which are conducted in rural markets.

SunLink has conducted its healthcare facilities business since 2001 and its specialty pharmacy business since April 2008. Our Specialty Pharmacy Segment currently is operated through Carmichael s Cashway Pharmacy, Inc. (Carmichael), a subsidiary of our ScriptsRx LLC subsidiary and consists of a specialty pharmacy business acquired in April 2008 with four service lines.

Strategy

SunLink s business strategy is to focus its efforts on internal growth of its existing healthcare facilities and its pharmacy business, supplemented by growth from selected rural and exurban healthcare acquisitions, including but not limited to hospitals, nursing homes, home care businesses, and pharmacy businesses. However, as was the case in 2004 with the sale of our Mountainside Medical Center hospital and in September 2009 with the sale of three home health

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

agencies, we do consider disposition of one or more of our facilities or operations based on a variety of factors including asset values, return on investments, competition from existing and potential facilities and capital improvement needs and other corporate objectives. We likewise evaluate our strategic alternatives on an on-going basis.

Our operational strategy is focused on efforts to increase internal growth. Our primary operational strategy for our community hospitals is to improve the profitability of such hospitals by reducing out-migration of patients, recruiting physicians, expanding services and implementing and maintaining effective cost controls. Our operational strategy for our nursing homes and home health agency is similar to that for our community hospitals and is focused on marketing services and implementing and maintaining effective cost controls.

Finally, our operational strategy for our specialty pharmacy segment is focused on continuing the integration of the Carmichael operations acquired in April 2008, increasing collection efforts, marketing services and implementing and maintaining effective cost controls.

Note 3. Sale of Home Health Businesses

In September 2009, we sold three of our home health businesses for approximately $3,300 resulting in a pre-tax gain of approximately $2,342 for the six months ended December 31, 2009. Included in the net assets of the three home health businesses sold was $429 of goodwill related to our Healthcare Facilities Segment. The home health businesses were located in Adel, GA, Clanton, AL and Fulton, MO.

Note 4. Discontinued Operations

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

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Loss from discontinued operations:				
Housewares Segment:				
Loss from operations	$ (139)	$ (122)	$ (174)	$ (140)
Income tax benefit	(42)	(48)	(59)	(55)
Loss from Housewares Segment after taxes	(97)	(74)	(115)	(85)
Mountainside Medical				
Loss from operations	(6)	(33)	(43)	(98)
Income tax benefit	(2)	(13)	(15)	(37)
Loss from Mountainside Medical Center after taxes	(4)	(20)	(28)	(61)
Life sciences and engineering segment:				

Loss from operations	(18)	(14)	(35)	(29)
Income tax benefit	(6)	(5)	(12)	(11)
Loss from life sciences and engineering segment after taxes	(12)	(9)	(23)	(18)
Loss from discontinued operations	$ (113)	$ (103)	$ (166)	$ (164)

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

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. KRUG UK was placed into involuntary liquidation by the U.K. High Court in February 2005. SunLink s non-current liability reserves for discontinued operations at December 31, 2009, included a reserve for a portion of the Beldray Guarantee, which would include certain amounts sought pursuant to the application made by the liquidator of KRUG UK. The pre-tax losses in the three and six month periods ended December 31, 2009 with respect to the former housewares segment operations resulted primarily from legal expenses related to the claim made by the liquidator. See the Legal Proceedings subsection in Note 14 Commitments and Contingencies which follows for additional disclosure with respect to such application.

Mountainside Medical Center On June 1, 2004, SunLink sold its Mountainside Medical Center (Mountainside) hospital in Jasper, Georgia, for approximately $40,000 pursuant to the terms of an asset sale agreement. The retained liabilities of Mountainside are shown in current liabilities of Mountainside on the consolidated balance sheet. The pre-tax losses in the three and six month periods ended December 31, 2009 with respect to the former Mountainside operations resulted primarily from legal expenses related to a claim made by the buyer of Mountainside and a counterclaim made by SunLink. See the Legal Proceedings subsection in Note 14 Commitments and Contingencies which follows for additional disclosure with respect to the claims.

Life Sciences and Engineering Segment SunLink retained a defined benefit retirement plan which covered substantially all of the employees of this segment when it was sold in fiscal 1998. Effective February 28, 1997, the plan was amended to freeze participant benefits and close the plan to new participants. Included in discontinued operations for the three and six month periods ended December 31, 2009 and 2008, respectively, were the following:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Interest cost	18	18	36	36
Expected return on assets	(11)	(13)	(22)	(25)
Amortization of prior service cost	11	9	21	18
Net pension expense	18	14	35	29

SunLink did not contribute to the plan in the six months ended December 31, 2009. We expect to make no contribution to the plan through the end of the fiscal year ending June 30, 2010.

Discontinued Operations Reserves Over the past 20 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.

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SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

Note 5. Stock-Based Compensation

For the three months ended December 31, 2009 and 2008, the Company recognized $10 and $26, respectively, in salaries, wages and benefit expense for share options issued to employees and directors of the Company and for the six months ended December 31, 2009 and 2008, the Company recognized $23 and $147, respectively, in salaries, wages and benefit expense for share options issued to employees and directors of the Company. The fair value of the share options granted was estimated using the Black-Scholes option pricing model. There were no share options granted during the six months ended December 31, 2009 and 28,000 share options granted during the six months ended December 31, 2008.

Note 6. Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (ASC 105, *Generally Accepted Accounting Principles*) ASC 105 . ASC 105 replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, and establishes the *FASB Accounting Standards Codification* (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. On the effective date of this Statement, the Codification will supersede all then-existing non-SEC accounting and reporting standards. ASC 105 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The codification is effective for the accompanying interim financial statements and the principal impact is limited to disclosures as all future references to authoritative literature will be referenced in accordance with the codification.

In September 2006, the FASB issued new accounting guidance related to fair value measurements and related disclosures. This new guidance defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. We adopted this new guidance on July 1, 2008, as required for our financial assets and financial liabilities. However, the FASB deferred the effective date of this new guidance for one year as it related to fair value measurement requirements for nonfinancial assets and liabilities that are recognized or disclosed at fair value on a recurring basis. We adopted these remaining provisions on July 1, 2009. The adoption of this accounting guidance did not have a material impact on our consolidated financial statements.

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 six years.

In December 2007, the FASB issued new accounting guidance related to the accounting for noncontrolling interests in consolidated financial statements. This guidance establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This guidance requires that noncontrolling interests in subsidiaries be reported in the equity section of the controlling company s balance sheet. It also changes the manner in which the net income of the subsidiary is reported and disclosed in the controlling company s income statement. This guidance is effective for fiscal years beginning after December 15, 2008. We adopted this guidance on July 1, 2009 and reclassified minority interest to the equity section of the balance sheet. (See Note 12 Noncontrolling Interest)

Management, in accordance with guidance regarding subsequent events, has evaluated subsequent events for recognition or disclosure through the date these financial statements were issued, February 10, 2010.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

Note 7. Receivables- net

Summary information for receivables is as follows:

	December 31, 2009	June 30, 2009
Accounts receceivable (net of contractual allowances)	$ 34,009	$ 36,077
Less allowance for doubtful accounts	(15,833)	(14,961)
Receivables - net	$ 18,176	$ 21,116

Net revenues included increases of $559 and $24 for the three months ended December 31, 2009 and 2008, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports. Net revenues included increases of $459 and $272 for the six months ended December 31, 2009 and 2008, respectively, for the settlements of prior year Medicare and Medicaid cost reports.

Note 8. Goodwill And Intangible Assets

SunLink has goodwill and intangible assets related to its Healthcare Facilities and Specialty Pharmacy segments.

Intangibles consist of the following, net of amortization:

	December 31, 2009	June 30, 2009
Healthcare Facilities Segment		
Certificates of Need	$ 630	$ 630
Noncompetition Agreements	266	266
	896	896
Accumulated Amortization	(357)	(301)
	$ 539	$ 595
Specialty Pharmacy Segment		
Trade Name	5,400	5,400
Customer Relationships	6,400	6,400
Medicare License	769	769
Noncompetition Agreements	290	290
	12,859	12,859
Accumulated Amortization	(1,233)	(867)

		11,626	11,992
Total	$	12,165	$ 12,587

Amortization expense was $211 and $226 for the quarters ended December 31, 2009 and 2008, respectively. Amortization expense was $422 and $452 for the six months ended December 31, 2009 and 2008, respectively.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

Goodwill consists of the following:

	December 31, 2009	June 30, 2009
Healthcare Facilities Segment	$ 2,515	$ 2,944
Specialty Pharmacy Segment	6,509	6,509
	$ 9,024	$ 9,453

In September 2009, we sold three of our home health businesses for approximately $3,300. Included in the net assets of the three home health businesses sold was $429 of goodwill related to our Healthcare Facilities Segment.

Note 9. Long-Term Debt

Long-term debt consisted of the following:

	December 31, 2009	June 30, 2009
Term Loan	$ 31,711	$ 32,587
Capital lease obligations	73	108
Total	31,784	32,695
Less current maturities	(1,795)	(1,808)
	$ 29,989	$ 30,887

SunLink Credit Facilities On April 23, 2008, SunLink entered into a $47,000 seven-year senior secured credit facility (Credit Facility) comprised of a revolving line of credit of up to $12,000 with an interest rate at LIBOR plus 3.50% (6.25% at December 31, 2009) (the Revolving Loan) and a $35,000 term loan with an interest rate at LIBOR plus 5.07% (7.82% at December 31, 2009) (the Term Loan). In the Credit Facility, LIBOR is defined as the Thirty-Day published rate, not to be less than 2.75%, nor more than 5.50%. The total availability of credit under all components of the credit facility is keyed to the level of SunLink s earnings, which, based upon the Company s estimates, provided for current borrowing capacity, before any draws, of approximately $40,720 at December 31, 2009. Costs and fees related to execution of the Credit Facility were $2,157. The fees will be amortized over seven years at approximately $331 a year and are recorded in other assets and other non-current assets. Amortization expense was approximately $95 and $192, respectively, for the quarter and six months ended December 31, 2009 and $95 and $187, respectively, for the quarter and six months ended December 31, 2008. Accumulated amortization was approximately $631 and $248 at December 31, 2009 and 2008, respectively. The Credit Facility is secured by a first priority security interest in substantially all real and personal property of the Company and its consolidated domestic subsidiaries, including a pledge of all of the equity interests in such subsidiaries.

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SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

Note 10. Subordinated Long-Term Debt

Subordinated long-term debt consisted of the following:

	December 31, 2009	June 30, 2009
Carmichael	$ 2,700	$ 2,850
Less current maturities	(300)	(300)
	$ 2,400	$ 2,550

Carmichael Loan On April 22, 2008, SunLink Scripts Rx, LLC (formerly known as SunLink Homecare Services LLC) entered into a $3,000 promissory note agreement with an interest rate of 8% with the former owners of Carmichael as part of the acquisition purchase price. The note is payable in semi-annual installments of $150 beginning on April 22, 2009 with the remaining balance of $1,200 due April 22, 2015. Interest is payable in arrears semi-annually on the six-month anniversary of the issuance of the note. The note is guaranteed by SunLink Health Systems, Inc. for the payment of the note and accrued interest. The note is subordinate to our Credit Facility.

Note 11. Income Taxes

Income tax benefit of $365 ($308 federal tax benefit and $57 state tax benefit) and income tax benefit of $84 ($58 federal tax benefit and $26 state tax benefit) was recorded for the three months ended December 31, 2009 and 2008, respectively. Income tax expense of $218 ($218 federal tax expense and $0 state tax expense) and income tax benefit of $650 ($577 federal tax benefit and $73 state tax benefit) was recorded for the six months ended December 31, 2009 and 2008, respectively. The high effective income tax rate of 61.0% for the six months ended December 31, 2009 resulted from the tax non-deductibility of $429 of goodwill included in the net assets of the home health businesses sold during in September 2009.

We had an estimated net operating loss carry-forward for federal income tax purposes of approximately $6,300 at December 31, 2009. Use of this net operating loss carry-forward is subject to the limitations of the provisions of Internal Revenue Code Section 382. As a result, not all of the net operating loss carry-forward is available to offset federal taxable income in the current year. At December 31, 2009, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was $4,048. Based upon management s assessment that it was more likely than not that a portion of its domestic deferred tax asset (primarily its domestic net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the domestic tax asset which may not be utilized. The Company has provided a valuation allowance for the entire amount of the foreign tax asset as it is more likely than not that none of the foreign deferred tax assets will be realized through future taxable income or implementation of tax planning strategies.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

The Company accounts for uncertainty in income taxes for a change in judgment related to prior years tax positions in the quarter of such change. Activity in the unrecognized tax benefit liability account is as follows from July 1, 2008 through December 31, 2009:

Balance at July 1, 2008	$ 58
Additions based on tax positions related to current year	31
Reduction for tax positions of prior years	(23)
Balance at June 30, 2009	66
Additions based on tax positions related to current year	5
Reduction for tax positions of prior years	(14)
Balance at December 31, 2009	$ 57

SunLink or one or more of our subsidiaries files income tax returns with the United States, various states in the United States and in certain foreign jurisdictions. We are not currently subject to U.S. federal, state or local, or non-U.S. income tax examinations by tax authorities for any tax years. We therefore believe that there is no tax jurisdiction in which the outcome of unresolved issues or claims is likely to be material to our financial position, cash flows or results of operations. We further believe that we have made adequate provision for all income tax uncertainties.

At July 1, 2009, our unrecognized tax benefits, the aggregate tax effect of differences between tax return positions and the benefits recognized in our financial statements as shown above, amounted to $66. If recognized, all of our unrecognized tax benefits would not reduce our income tax expense or effective tax rate except as such recognition related to the removal of the liability associated with interest classified as income tax expense. No portion of any such reduction might be reported as discontinued operations. During fiscal year 2010, certain factors could potentially reduce our unrecognized tax benefits, either because of the expiration of open statutes of limitation or modifications to our intercompany accounting policies and procedures. Of these tax positions, none relate to positions that would affect our total tax provision or effective tax rate (except as such recognition related to the removal of the liability associated with interest classified as income tax expense).

We classify interest accrued on tax deficiencies as tax expense and classify income tax penalties as tax expense. At December 31, 2009, before any tax benefits, our accrued interest on unrecognized tax benefits amounted to $16 and we had recorded no related accrued penalties.

Note 12. Noncontrolling Interest

On February 1, 2008, SunLink sold 17% of the Chilton Medical Center in Clanton, Alabama, to individual physicians, most of whom practice at that facility. The noncontrolling interest reported reflects these physicians ownership interest at December 31, 2009. The results of operations for the period from February 1, 2008 to December 31, 2009 were a loss and did not impact the physicians ownership interest. In December 2007, the FASB issued new guidance relating to accounting for noncontrolling interests in consolidated financial statements and requires that noncontrolling interest in subsidiaries be reported in the equity section of the controlling company s balance sheet. The Company adopted this guidance on July 1, 2009 and has retroactively adjusted the accompanying June 30, 2009 condensed consolidated balance sheet to conform to this accounting standard and the December 31, 2009 presentation.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

Note 13. Comprehensive Earnings

Our comprehensive earnings include foreign currency translation adjustments and change in minimum pension liability. The foreign currency translation adjustment results primarily from the effect of changes in the exchange rates of the UK pound on our reserve for the Beldray Guarantee (See Note 4. *Discontinued Operations*).

Total comprehensive earnings for the following periods were as follows:

	Three Months Ended December 31, 2009	Three Months Ended December 31, 2008	Six Months Ended December 31, 2009	Six Months Ended December 31, 2008
Net loss	$ (524)	$ (264)	$ (28)	$ (928)
Other comprehensive income (loss) net of tax:				
Change in equity due to:				
Foreign currency translation adjustments	(9)	165	15	333
Comprehensive loss	$ (533)	$ (99)	$ (13)	$ (595)

Note 14. Commitments and Contingencies

Legal Proceedings

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

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

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

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On October 13, 2008, the Superior Court of Cobb County, Georgia, ruled in SunLink s favor and determined that the May and August 2006 DSH payments constitute excluded assets not sold to PMH under the Agreement and, therefore, the right to receive the payments belonged to SunLink. By PMH retaining the payments for itself and failing to pay an equivalent amount of money to SunLink, PMH was in breach of the agreement. PMH is liable to SunLink for damages in the net amount of $1,056 ($1,560 in DSH payments minus $504 SHCJ owed PMH pursuant to the Agreement), plus prejudgment interest from August 11, 2006 to November 11, 2008 at the legal rate of 7%, and post-judgment interest after November 11, 2008. Piedmont appealed the Superior Court of Cobb County, Georgia ruling to the Georgia Court of Appeals. On November 30, 2009, the Georgia Court of Appeals affirmed the judgment in favor of SunLink in all respects. In December of 2009, Piedmont filed a petition for *certiorari* requesting that the Georgia Supreme Court hear the case. SunLink opposed the petition, and the Georgia Supreme Court has not yet issued a ruling regarding whether it will hear the appeal. Therefore, SunLink has not recorded a receivable for the judgment amount, offset the amounts owing to PMH, or any prejudgment interest.

On December 7, 2007, Southern Health Corporation of Ellijay, Inc. (SHC-Ellijay) filed a Complaint against James P. Garrett and Roberta Mundy, both individually and as Fiduciary of the Estate of Randy Mundy (collectively, the Mundys), seeking specific performance of an Option Agreement (the Option Agreement) dated April 17, 2007, between SHC-Ellijay, Mr. Garrett, and Ms. Mundy as Executrix of the Estate of Randy Mundy for the sale of approximately 24.74 acres of real property located in Gilmer County, Georgia, and recovery of SHC-Ellijay s damages suffered as a result of the Mundys failure to close the transaction in accordance with the Option Agreement. SHC-Ellijay also stated alternative claims for breach of the Option Agreement and fraud, along with claims to recover attorney s fees and punitive damages.

In January 2008, the Mundys filed a motion to strike, motion to dismiss, answer, affirmative defenses, and a counterclaim against SHC-Ellijay. On March 3, 2009, SHC-Ellijay filed a First Amended and Restated Complaint for Damages, which effectively dropped the cause of action for specific performance of the Option Agreement. On May 7, 2009, Mr. Garrett and Ms. Mundy served a motion for summary judgment on all counts and causes of action stated in the First Amended Complaint. The court has postponed consideration of the defendants motion for summary judgment and SHC-Ellijay s response thereto until after a discovery dispute between the parties has been resolved.

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

As discussed in Note 4. *Discontinued Operations* , SunLink sold its former U.K. housewares manufacturing subsidiary, Beldray Limited (Beldray) in October 2001. Beldray subsequently entered into administrative receivership under the administration of its primary lender. SunLink believes Beldray ceased to operate in October 2004.

On August 6, 2007 the liquidator in an insolvency proceeding in the United Kingdom involving SunLink s former subsidiary KRUG International (UK) Limited (KRUG UK) made an application in The Birmingham County Court in Birmingham, England seeking a declaration by the court that a transfer of certain funds in 2001 from KRUG UK to SunLink in connection with the purchase of certain preferred stock of another subsidiary of SunLink, the making of a loan to SunLink, and certain forgiveness of debt to SunLink by KRUG UK Limited was improper as,

SUNLINK HEALTH SYSTEMS, INC.

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THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

among other things, KRUG UK was then effectively insolvent and that the approval of such transfers 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, SunLink, to account for, repay or restore such funds to the liquidator of KRUG UK. This case is scheduled to go to trial in April 2010.

In connection with the allegations in the application of breach of fiduciary duty by the directors of KRUG UK in approving the transfer of such funds, SunLink has indemnification obligations to the former directors of KRUG UK. SunLink has denied any liability to KRUG UK other than to it in KRUG UK s status as a preferred stockholder and for the balance on a promissory note, which unpaid balance on such note was paid by SunLink at maturity in August 2008. 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 December 31, 2009, 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. A proof of debt has been accepted by the insolvency liquidator for approximately $1,660 for the Beldray Guarantee. SunLink expensed $174 in the quarter ended December 31, 2009 on legal costs to defend against the claim. 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 year 1989 and for guarantees of certain obligations of former subsidiaries. SunLink provided an accrual at December 31, 2009 related to the Beldray Lease Guarantee, as discussed above. 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.

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 SunLink. SunLink expenses legal costs as they are incurred.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases, physician guarantees and interest on outstanding debt from continuing operations at December 31, 2009 were as follows:

Payments due in:	Long-Term Debt	Subordinated Long-Term Debt	Operating Leases	Physician Guarantees	Interest On Outstanding Debt	Interest On Subordinated Outstanding Debt
1 year (2010)	$ 1,795	$ 300	$ 2,540	$ 749	$ 2,415	$ 222
2 years (2011)	1,778	300	1,091		2,275	200
3 years (2012)	1,750	300	634		2,138	176
4 years (2013)	1,750	300	400		2,001	152
5 years (2014)	1,750	300	288		1,864	128
5 years +	22,961	1,200	1,060		1,796	104
	$ 31,784	$ 2,700	$ 6,013	$ 749	$ 12,489	$ 982

At December 31, 2009, SunLink had contracts with two physicians which contained guaranteed minimum gross receipts. A physician with whom a guarantee agreement is made generally agrees to maintain his/her practice within the hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician s liability for any guarantee repayment due to non-compliance with guarantee provisions generally is collateralized by the physician s patient accounts receivable and/or a promissory note from the physician. Included in the Company s consolidated balance sheet at December 31, 2009 is a liability of $331 for two physician guarantees. SunLink expensed $207 and $195 on physician guarantees and recruiting for the three months ended December 31, 2009 and 2008, respectively and expensed $434 and $384 on physician guarantees and recruiting for the six months ended December 31, 2009 and 2008, respectively. The table above shows non-cancelable commitments under physician guarantee contracts as of December 31, 2009.

Note 15. Related Party Transactions

A director of the Company and our company secretary (who was a director of SunLink until November 2003 and is now a director emeritus) are members of two different law firms, each of which provides services to SunLink. The Company has paid an aggregate of $67 and $114 for legal services to these law firms in the three months ended December 31, 2009 and 2008, respectively, and $252 and $315 for the six months ended December 31, 2009 and 2008, respectively.

Note 16. Financial Information By Segments

Prior to the acquisition of Carmichael in April 2008, we operated as a single business segment. Under ASC Topic No. 280, Segment Reporting, operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-making group is composed of the chief executive officer and members of senior management. Our two reportable operating segments are Healthcare Facilities and Specialty Pharmacy.

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SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED DECEMBER 31, 2009

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

(unaudited)

We evaluate performance of our operating segments based on revenue and operating income (loss). Segment information for the quarter and six months ended December 31, 2009 is as follows:

	Healthcare Facilities	Specialty Pharmacy	Corporate And Other	Total
Three months ended December 31, 2009				
Net Revenues from external customers	$ 37,619	$ 12,526	$	$ 50,145
Operating income (loss)	1,310	(109)	(1,124)	77
Depreciation and amortization	1,164	417	114	1,695
Assets	63,619	27,319	10,861	101,799
Expenditures for property, plant and equipment	229	131	105	465
Six months ended December 31, 2009				
Net Revenues from external customers	$ 75,112	$ 22,858	$	$ 97,970
Operating income (loss)	4,348	182	(2,405)	2,125
Depreciation and amortization	2,321	814	222	3,357
Assets	63,619	27,319	10,861	101,799
Expenditures for property, plant and equipment	835	396	106	1,337

	Healthcare Facilities	Specialty Pharmacy	Corporate And Other	Total
Three months ended December 31, 2008				
Net Revenues from external customers	$ 36,430	$ 13,328	$	$ 49,758
Operating income (loss)	1,236	745	(1,144)	837
Depreciation and amortization	1,209	379	111	1,699
Assets	71,517	28,803	8,237	108,557
Expenditures for property, plant and equipment	209	80	34	323
Six months ended December 31, 2008				
Net Revenues from external customers	$ 73,497	$ 22,939	$	$ 96,436
Operating income (loss)	2,598	991	(2,674)	915
Depreciation and amortization	2,421	754	229	3,404
Assets	71,517	28,803	8,237	108,557
Expenditures for property, plant and equipment	342	187	176	705

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

Forward-Looking Statements

This Quarterly Report and the documents that are incorporated by reference in this Quarterly Report contain certain forward-looking statements within the meaning of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that do not relate solely to historical or current facts and may be identified by the use of words such as may, believe, will, expect, project, estimate, anticipate, plan or continue. These forward-looking statements are ba 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;
- the competitive nature of the U.S. community hospital, nursing home, homecare and specialty pharmacy businesses;
- demographic changes in areas where we operate;
- the availability of cash or borrowings to fund working capital, renovations, replacements, expansions 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

- inability to operate profitability in one or more segments of the healthcare business;
- the availability of, and our ability to attract and retain, sufficient qualified staff physicians, management, nurses, pharmacists and staff personnel for our 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 and pharmacy operations;

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

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

the functionality or costs with respect to our information systems for our healthcare facilities and specialty pharmacy segments and our corporate office, including both software and hardware; and

the availability and competition from alternative drugs or treatments provided by our specialty pharmacy segment;

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;

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

weather-related events such as flooding, wind damage and population evacuations affecting areas in which we operate, including Louisiana and South Georgia.

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 including healthcare reform proposals currently being debated in Congress; and,

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

Acquisition Related Matters

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

impairment or uncollectibility of certain acquired assets;

assumed liabilities discovered subsequent to an acquisition;

our ability to integrate acquired healthcare businesses and implement our business strategy; and, competition in the market for acquisitions of hospitals and healthcare businesses.

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

Corporate Business Strategy

SunLink s business strategy is to focus its efforts on internal growth of its existing healthcare facilities and its pharmacy business, supplemented by growth from selected rural and exurban healthcare acquisitions, including but not limited to hospitals, nursing homes, home care businesses, and pharmacy businesses. However, as was the case in 2004 with the sale of our Mountainside Medical Center hospital and in September 2009 with the sale of three home health agencies, we do consider disposition of one or more of our facilities or operations based on a variety of factors including asset values, return on investments, competition from existing and potential facilities and capital improvement needs and other corporate objectives. We likewise evaluate our strategic alternatives on an on-going basis.

Our operational strategy is focused on efforts to increase internal growth. Our primary operational strategy for our community hospitals is to improve the profitability of such hospitals by reducing out-migration of patients, recruiting physicians, expanding services and implementing and maintaining effective cost controls. Our operational strategy for our nursing homes and home health agency is similar to that for our community hospitals and is focused on marketing services and implementing and maintaining effective cost controls.

Finally, our operational strategy for our specialty pharmacy segment is focused on continuing the integration of the Carmichael operations acquired in April 2008, increasing collection efforts, marketing services and implementing and maintaining effective cost controls.

Critical Accounting Estimates

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

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

Our critical accounting estimates are more fully described in our 2009 Annual Report on Form 10-K and continue to include the following areas:

- Receivables net and provision for doubtful accounts;
- Revenue recognition / Net Patient Service Revenues;
- Goodwill and accounting for business combinations;
- Professional and general liability claims; and
- Accounting for income taxes.

Financial Summary

The results of continuing operations shown in the financial summary below are for our two business segments, Healthcare Facilities and Specialty Pharmacy.

Equivalent admissions Equivalent admissions is used by management (and certain investors) as a general measure of combined inpatient and outpatient volume for our hospital operations. 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).

	THREE MONTHS ENDED December 31,			**SIX MONTHS ENDED December 31,**		
	2009	**2008**	**% Change**	**2009**	**2008**	**% Change**
Net Revenues - Healthcare Facilities	$ 37,619	$ 36,430	3.3%	$ 75,112	$ 73,497	2.2%
Net Revenues - Specialty Pharmacy	12,526	13,328	-6.0%	22,858	22,939	-0.4%
Total Net Revenues	50,145	49,758	0.8%	97,970	96,436	1.6%
Costs and expenses	(50,068)	(48,921)	2.3%	(98,187)	(95,521)	2.8%
Gain on sale of Home Health businesses			N/A	2,342		N/A
Operating profit	77	837	-90.8%	2,125	915	132.2%
Gain on sale of assets		180	N/A		180	N/A
Interest expense	(859)					