DYNACQ HEALTHCARE INC
Form 10-Q
January 14, 2014

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

FORM 10-Q

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

For the quarterly period ended November 30, 2013

¨ 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: 000-21574

DYNACQ HEALTHCARE, INC.
(Exact name of registrant as specified in its charter)

Nevada (State or other jurisdiction of incorporation or organization)	**76-0375477** (I.R.S. Employer Identification No.)
4301 Vista Road **Pasadena, Texas** (Address of principal executive offices)	**77504** (Zip Code)

(713) 378-2000
(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 filing 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 (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. (Check One):

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

As of January 10, 2014, the number of shares outstanding of the registrant's common stock, par value $.001 per share, was 14,418,626.

Table of Contents

2

PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

Dynacq Healthcare, Inc.
Consolidated Balance Sheets

	November 30, 2013 (Unaudited)		August 31, 2013	
Assets				
Current assets:				
Cash and cash equivalents	$	13,478,867	$	13,585,447
Accounts receivable, net of allowances of approximately $166,142,000 and $170,198,000		1,680,702		1,062,029
Inventories		276,908		293,565
Trading securities				1,071,346
Interest receivable		147,165		102,964
Prepaid expenses		153,469		180,883
Income tax receivable		569,430		569,430
Total current assets		16,306,541		16,865,664
Investments available-for-sale		19,338,745		17,458,985
Property and equipment, net		6,238,836		6,323,657
Income tax receivable		800,920		800,920
Other assets		187,102		187,101
Total assets	$	42,872,144	$	41,636,327

The accompanying notes are an integral part of these consolidated financial statements.

3

Dynacq Healthcare, Inc.
Consolidated Balance Sheets (continued)

	November 30, 2013 (Unaudited)	August 31, 2013
Liabilities and equity		
Current liabilities:		
Accounts payable	$ 1,169,304	$ 1,012,328
Accrued liabilities	11,803,858	11,845,317
Current portion of notes payable	37,107	40,256
Current portion of capital lease obligations	91,593	115,737
Total current liabilities	13,101,862	13,013,638
Non-current liabilities:		
Long-term portion of notes payable		6,744
Long-term portion of capital lease obligations	62,918	69,978
Total liabilities	13,164,780	13,090,360
Commitments and contingencies		
Equity:		
Dynacq stockholders' equity:		
Preferred stock, $.01 par value; 5,000,000 shares authorized, none issued or outstanding		
Common stock, $.001 par value; 100,000,000 shares authorized, 14,543,626 shares issued and 14,418,626 outstanding at November 30, 2013; 14,543,626 shares issued and outstanding at August 31, 2013	14,544	14,544
Treasury stock, 125,000 and 0 shares at November 30, 2013 and August 31, 2013, at cost		
Additional paid-in capital	10,331,597	10,282,256
Accumulated other comprehensive income	11,203,250	9,382,334
Retained earnings	8,094,575	8,803,410
Total Dynacq stockholders' equity	29,643,966	28,482,544
Non-controlling interest	63,398	63,423
Total equity	29,707,364	28,545,967
Total liabilities and equity	$ 42,872,144	$ 41,636,327

The accompanying notes are an integral part of these consolidated financial statements.

Dynacq Healthcare, Inc.
Consolidated Statements of Operations
(Unaudited)

	Three months ended November 30,			
	2013		2012	
Net patient service revenue	$	2,259,247	$	1,518,027
Costs and expenses:				
Compensation and benefits		1,451,767		1,388,824
Medical services and supplies		617,470		395,540
Other operating expenses		1,112,478		2,572,251
Depreciation and amortization		108,309		123,752
Total costs and expenses		3,290,024		4,480,367
Operating loss		(1,030,777)		(2,962,340)
Other income (expense):				
Rent and other income		275,545		2,969,091
Interest income		202,323		304,814
Interest expense		(155,952)		(141,261)
Total other income, net		321,916		3,132,644
Income (loss) before income taxes from continuing operations		(708,861)		170,304
Provision (benefit) for income taxes				
Income (loss) from continuing operations		(708,861)		170,304
Discontinued operations, net of income taxes				241,358
Net income (loss)		(708,861)		411,662
Less: Net loss attributable to noncontrolling interest		26		2,798
Net income (loss) attributable to Dynacq Healthcare, Inc.	$	(708,835)	$	414,460
Basic and diluted income (loss) per common share:				
Income (loss) from continuing operations attributable to Dynacq Healthcare, Inc.	$	(0.05)	$	0.01
Discontinued operations, net of income taxes				0.02
Net income (loss) attributable to Dynacq Healthcare, Inc.	$	(0.05)	$	0.03
Basic and diluted average common shares outstanding		14,449,876		14,543,626

The accompanying notes are an integral part of these consolidated financial statements.

Dynacq Healthcare, Inc.

Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

	Three months ended November 30,			
	2013		2012	
Net income (loss)	$	(708,861)	$	411,662
Other comprehensive income (loss), net of taxes:				
Net change in foreign currency translation adjustment, net of taxes of $-0- and $(4,414)				(8,196)
Net change in fair value of available-for-sale securities, net of taxes of $-0-		1,820,916		(1,000,495)
Other comprehensive income (loss)		1,820,916		(1,008,691)
Comprehensive income (loss)		1,112,055		(597,029)
Less comprehensive loss attributable to noncontrolling interest		26		2,798
Comprehensive income (loss) attributable to Dynacq Healthcare, Inc.	$	1,112,081	$	(594,231)

The accompanying notes are an integral part of these consolidated financial statements.

Dynacq Healthcare, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

	Three months ended November 30, 2013		2012	
Cash flows from operating activities				
Net income (loss)	$	(708,861)	$	411,662
Less (income) loss from discontinued operations, net of income taxes				(241,358)
Net income (loss) before discontinued operations		(708,861)		170,304
Adjustments to reconcile net income (loss) before discontinued operations to net cash from operating activities:				
Depreciation and amortization		108,309		123,752
Gain on sale of investments available-for-sale and trading securities		(161,864)		(2,257,878)
Gain on sale of investment in real estate				(480,108)
Stock based compensation		49,341		(33,547)
Foreign currency exchange gains		(58,920)		(77,099)
Changes in operating assets and liabilities:				
Accounts receivable		(618,673)		81,399
Interest receivable		(44,201)		(29,214)
Inventories		16,657		96,670
Prepaid expenses		27,414		71,435
Other assets				49,688
Accounts payable		156,976		(571,550)
Accrued liabilities		(41,459)		(135,513)
Cash from continuing activities		(1,275,281)		(2,991,661)
Cash from discontinued activities				241,358
Net cash from operating activities		(1,275,281)		(2,750,303)
Cash flows from investing activities				
Sales proceeds of trading securities		1,233,286		2,650,000
Sales proceeds of investment in real estate				2,365,017
Purchase of equipment		(23,488)		(797)
Cash from continuing activities		1,209,798		5,014,220
Cash from discontinued activities				
Net cash from investing activities		1,209,798		5,014,220
Cash flows from financing activities				
Principal payments on notes payable		(9,893)		(1,100,737)
Payments on capital lease		(31,204)		(24,683)
Cash from continuing activities		(41,097)		(1,125,420)
Cash from discontinued activities				
Net cash from financing activities		(41,097)		(1,125,420)
Net change in cash and cash equivalents		(106,580)		1,138,497
Cash at beginning of period		13,585,447		10,638,217
Cash at end of period	$	13,478,867	$	11,776,714
Supplemental cash flow disclosures				
Cash paid during the period for:				

Interest	$	17,829	$	201,608
Income taxes	$	0	$	0
Non cash investing and financing activities:				
Unrealized change in fair value of available-for-sale securities	$	1,820,916	$	(1,000,495)

The accompanying notes are an integral part of these consolidated financial statements.

Dynacq Healthcare, Inc.

Notes to Consolidated Financial Statements

November 30, 2013
(Unaudited)

General

Dynacq Healthcare, Inc., a Nevada corporation (the "Company"), is a holding company that through its subsidiaries in the United States develops and manages general acute care hospitals that principally provide specialized surgeries. The Company through its United States subsidiaries owns and operates one general acute care hospital in Pasadena, Texas. The Company through its subsidiary in Hong Kong invests in debt and equity securities, including short-term investments in initial public offerings and pre-initial public offerings.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal and recurring nature. The majority of the Company's expenses are "cost of revenue" items. Costs that could be classified as general and administrative by the Company would include the corporate office costs, including advertising and marketing expenses, which were approximately $0.9 million and $2.4 million for the three months ended November 30, 2013 and 2012, respectively. These financial statements should be read in conjunction with the audited financial statements as of August 31, 2013. Operating results for the three months ended November 30, 2013 are not necessarily indicative of the results that may be expected for the year ending August 31, 2014.

Reclassification

Certain previously reported financial information has been reclassified to conform to the current period's presentation. The impact of such reclassification was not significant to the prior period's overall presentation.

Cash and Cash Equivalents

The Company considers all highly liquid instruments with maturities of three months or less on the date of purchase to be cash equivalents. Cash equivalents are carried at cost, which approximates fair value.

Investments in Available-for-Sale and Trading Securities

The Company's investments in debt instruments (corporate and municipal bonds) are recorded at fair value based on quoted market prices that are traded in less active markets or priced using a quoted market price for similar investments or are priced using non-binding market consensus prices that can be corroborated by observable market data (Level 2). These investments are classified as available-for-sale securities. These investments are subject to default risk. Unrealized gains in the fair value are reported in accumulated other comprehensive income, net of related income tax effect. The Company regularly monitors its investment portfolio for any decline in fair value that is other than temporary and records any such impairment as an impairment loss. The determination of the gain or loss on the sale of any security is made using the specific identification method.

The Company also invests in initial public offerings of equity securities on the Hong Kong Stock Exchange. These investments are classified as trading securities, and are carried at fair value. These investments are subject to fluctuations in the market price. During the three months ended November 30, 2013 and 2012, the Company had a net gain of $161,864 and $58,378, respectively, in these securities. During the current period, the Company sold all of its trading securities and does not hold any such securities as of November 30, 2013.

Investment in Real Estate and Notes Payable

In October 2012, the Company sold an apartment in Hong Kong, which was purchased in March 2010. The net proceeds from the sale of the apartment were $1,273,403, after repayment of the associated note payable, resulting in a gain of $480,108.

In November 2011 and September 2010, the Company borrowed $116,339 and $65,000 as notes payable from a financial institution at an interest rate of 4.5% and 6%, which notes are to be repaid in 36 and 24 monthly installments, respectively, and are secured by specific equipment purchased at our Pasadena facility. The $65,000 note payable was fully repaid during the three months ended November 30, 2012. The Company paid down $9,893 during the three months ended November 30, 2013, and the current and long-term portions of the notes payable as of November 30, 2013 are $37,107 and $-0-, respectively.

Inventories

Inventories, consisting primarily of medical supplies, are stated at the lower of cost or market, with cost determined by use of the average cost method.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The most significant of the Company’s estimates is the determination of revenue to recognize for the services the Company provides and the determination of allowances, which includes the contractual allowance and the provision for doubtful accounts. See “Revenue Recognition” below for further discussion. Actual results could differ materially from those estimates used in the preparation of these financial statements.

Discontinued Operations

The Company classifies assets to be disposed of as held for sale or, if appropriate, discontinued operations when appropriate approvals for the disposal are made by management or the Board of Directors. Cash flows from discontinued businesses are reflected as discontinued operating, investing, and financing activities in our statement of cash flows.

The Company closed the Garland facility on September 30, 2011, and sold it in July 2013. The Company took an impairment charge of approximately $1.1 million during the three months ended August 31, 2012, based on the sales price negotiated at that time. An additional loss of $122,975 was taken based on the final sales price during the three months ended August 31, 2013.

The following is a summary of financial information related to our discontinued operations at the Garland facility for the three months ended November 30, 2012:

	Three months ended November 30, 2012	
Net patient service revenue	$	210,825
Total costs and expenses		290
Operating income		210,535
Other income (expense), net		30,823
Income before income taxes		241,358

Provision for income taxes		
Total income on discontinued operations, net of taxes	$	241,358

9

Net Income (Loss) per Share

The following table presents the computation of basic and diluted income (loss) per common share attributable to the Company:

	Three months ended November 30, 2013		2012	
Basic and diluted income (loss) per common share:				
Numerator:				
Income (loss) from continuing operations	$	(708,861)	$	170,304
Less: Net loss attributable to noncontrolling interest		26		2,798
Income (loss) from continuing operations attributable to Dynacq Healthcare, Inc.		(708,835)		173,102
Discontinued operations, net of income taxes				241,358
Net income (loss) attributable to Dynacq Healthcare, Inc.	$	(708,835)	$	414,460
Denominator:				
Basic and diluted average common shares outstanding		14,449,876		14,543,626
Basic and diluted income (loss) per common share:				
Income (loss) from continuing operations attributable to Dynacq Healthcare, Inc.	$	(0.05)	$	0.01
Discontinued operations, net of income taxes				0.02
Net income (loss) attributable to Dynacq Healthcare, Inc.	$	(0.05)	$	0.03

Basic net income (loss) per share is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted net income (loss) per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted net income (loss) per share, the basic weighted average number of shares is increased by the dilutive effect of stock options determined using the treasury stock method. However, if it is anti-dilutive, the dilutive effect of the stock options is not included in the calculation of diluted net income (loss) per share. Stock options with exercise prices exceeding current market prices that were excluded from the computation of net income (loss) per share amounted to approximately 1,087,000 shares and 2,310,000 shares for the three months ended November 30, 2013 and 2012, respectively.

Treasury Stock

In September 2013, as part of a settlement agreement with a former employee, the Company received 125,000 shares of common stock of the Company previously issued to him. These shares have been accounted for as treasury shares with zero cost.

Stock Based Compensation

Year 2011 Stock Incentive Plan

The purpose of the Year 2011 Stock Incentive Plan (“2011 Plan”) is to strengthen the Company by providing an incentive to its employees, officers, consultants and directors and to encourage them to devote their abilities and industry to the success of the Company’s business enterprise. It is intended that this purpose be achieved by extending to employees, officers, consultants and directors of the Company and its subsidiaries an added long-term incentive for high levels of performance and unusual efforts through the grant of incentive stock options, non-qualified stock options, stock appreciation rights, dividend equivalent rights, performance awards and restricted stock. The Company has reserved 15,000,000 shares of common stock for issuance under the 2011 Plan.

On January 12, 2012, the Compensation Committee granted stock options to purchase 250,000 shares under the 2011 Plan, with an exercise price of $1.10 to the Company's chief executive officer, Eric K. Chan. These stock options vest in annual installments of 25 percent beginning on the first anniversary date, and expire after ten years. The shares underlying these stock options are registered under the Securities Act.

As of November 30, 2013, there remain 250,000 shares to be issued upon exercise of outstanding options, and 14,750,000 shares which can be issued under the 2011 Plan after giving effect to shares issued and canceled.

2000 Incentive Plan

The Company's 2000 Incentive Plan ("2000 Plan") provides for options and other stock-based awards that may be granted to eligible employees, officers, consultants and non-employee directors of the Company or its subsidiaries. The Company had reserved 5,000,000 shares of common stock for future issuance under the 2000 Plan. The 2000 Plan does not have a fixed termination date, provided that no incentive stock option can be granted subsequent to August 29, 2011. As of November 30, 2013, there remain 820,850 shares to be issued upon exercise of outstanding options, and no new stock options awards will be issued under the 2000 Plan.

The following table summarizes the stock option activities for the three months ended November 30, 2013 (share amounts in thousands):

	Shares	Weighted Average Option Exercise Price Per Share
Outstanding, August 31, 2013	1,097	$ 2.21
Granted		
Exercised		
Expired or canceled	(26)	2.33
Outstanding, November 30, 2013	1,071	2.20

For the three months ended November 30, 2013 and 2012, there were no stock options exercised. The aggregate intrinsic value of the stock options outstanding as of November 30, 2013 and 2012 is $-0-, since the market price is lower than the exercise price.

The following summarizes information related to stock options outstanding as of November 30, 2013, and related weighted average price and life information:

		Options Outstanding		Options Exercisable
Exercise Prices		Number of Shares	Weighted Average Remaining Contractual Life (Years)	Number of Shares
		(Share Amounts In Thousands)		
$	1.10	250	8.1	63
$	1.86	638	7.6	319
$	4.90	183	1.0	183
	Total	1,071	6.6	565

For the three months ended November 30, 2013 and 2012, stock-based compensation expense associated with the Company’s stock options was $49,341 and $(33,547), respectively. The total unrecognized compensation expense for outstanding stock options as of November 30, 2013 was $329,000, and will be recognized, in general, over 1.7 years.

Fair Value of Financial Instruments

The fair value of financial instruments is estimated based on market trading information, where available. Absent published market values for an instrument or other assets, management uses observable market data to arrive at its estimates of fair value. Management believes that the carrying amount of cash and cash equivalents, accounts receivable and accrued liabilities approximate fair value. Fair value is defined as an exit price, representing the amount 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. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. A three-level fair value hierarchy prioritizes the inputs used to measure fair value. The three levels of inputs used to measure fair value are as follows:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted price for identical or similar assets and liabilities in markets that are not active; or other input that are observable or can be corroborated by observable market data.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

The following table summarizes our financial assets and liabilities measured and reported in the Company's statement of financial position at fair value on a recurring basis as of November 30, 2013, segregated among the appropriate levels within the fair value hierarchy:

	Quoted prices in active markets for identical (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable (Level 3)
Assets			
Investments available-for-sale	$	$ 19,338,745	$

The Company's investments in Level 2 are in perpetual debt instruments (corporate and municipal bonds) traded on the European markets, at a cost of $7,984,646, are recorded at fair value based on quoted market prices that are traded in less active markets or priced using a quoted market price for similar investments or are priced using non-binding market consensus prices that can be corroborated by observable market data (Level 2), and there has been no change in valuation techniques for these investments (Level 2).

Foreign Currency Translation

The functional currency of the Company as a whole is the U.S. Dollar. The Company has designated the U.S. Dollar as the functional currency for Sino Bond Inc. Limited, a Hong Kong corporation and wholly owned subsidiary of the Company ("Sino Bond"). The effects of foreign currency exchange adjustments are included as a component of Rent and Other Income in the Consolidated Statements of Operations.

Revenue Recognition

Background

The Company's revenue recognition policy is significant because net patient service revenue is a primary component of its results of operations. Revenue is recognized as services are delivered. The determination of the amount of revenue to be recognized in connection with the Company's services is subject to significant judgments and estimates, which are discussed below.

Revenue Recognition Policy

The Company has established billing rates for its medical services which it bills as gross revenue as services are delivered. Gross billed revenues are then reduced by the Company's estimate of allowances, which includes the contractual allowance and the provision for doubtful accounts, to arrive at net patient service revenues. Net patient service revenues may not represent amounts ultimately collected. The Company adjusts current period revenue for differences in estimated revenue recorded in prior periods and actual cash collections.

The following table shows gross revenues and allowances for the three months ended November 30, 2013 and 2012:

	2013	2012
Gross billed charges	$ 7,040,339	$ 4,647,003
Allowances	4,781,092	3,128,976
Net revenue	$ 2,259,247	$ 1,518,027

Allowance percentage	68 %	67 %

Contractual Allowance

The Company computes its contractual allowance based on the estimated collections on its gross billed charges. The Company computes its estimate by taking into account collections received, up to 30 days after the end of the period, for the services performed and also estimating amounts collectible for the services performed within the last six months. A significant amount of our net revenue results from Texas workers' compensation claims, which are governed by the rules and regulations of the Texas Department of Workers' Compensation ("TDWC") and the workers' compensation healthcare networks. If our hospital chooses to participate in a network, the amount of revenue that will be generated from workers' compensation claims will be governed by the network contract.

For claims arising prior to the implementation of workers' compensation networks and out of network claims, inpatient and outpatient surgical services are either reimbursed pursuant to the Acute Care In-Patient Hospital Fee Guideline or at a "fair and reasonable" rate for services in which the fee guideline is not applicable. Starting March 1, 2008, the Texas Workers' Compensation 2008 Acute Care Hospital Outpatient and Inpatient Facility Fee Guidelines (the "Guidelines") became effective. Under these Guidelines, the reimbursement amounts are determined by applying the most recently adopted and effective Medicare reimbursement formula and factors; however, if the maximum allowable reimbursement for the procedure performed cannot be calculated using these Guidelines, then reimbursement is determined on a fair and reasonable basis.

Based on these Guidelines, the reimbursement due the Company for workers' compensation cases is lower than we previously experienced. The Company has continued accepting Texas workers' compensation cases, and has not made any substantial changes in its focus towards such cases. Our net patient service revenue for Texas workers' compensation cases as a percentage of gross billings has decreased primarily as a result of lower reimbursement rates for workers' compensation procedures still being performed.

Should we disagree with the amount of reimbursement provided by a third-party payer, we are required to pursue the medical dispute resolution ("MDR") process at the TDWC to request proper reimbursement for services. From January 2007 to November 2008, the Company had been successful in its pursuit of collections regarding the stop-loss cases pending before the State Office of Administrative Hearings ("SOAH"), receiving positive rulings in over 90% of its claims presented for administrative determination. A 2007 district court decision upholding our interpretation of the statute as applied to the stop-loss claims was appealed by certain insurance carriers, and on November 13, 2008 the Third Court of Appeals determined that in order for a hospital to be reimbursed at 75% of its usual and customary audited charges for an inpatient admission, the hospital must not only bill at least $40,000, but also show that the admission involved unusually costly and unusually extensive services. Procedurally, the decision means that each case where a carrier raised an issue regarding whether the services provided were unusually costly or unusually extensive would be remanded to either SOAH or MDR for a case-by-case determination of whether the services provided meet these standards. As a result of the Third Court of Appeals opinion, any stop-loss cases pending at SOAH have been remanded to the TDWC since these cases have not been reviewed or decided by the two-prong standard decided by the Third Court of Appeals. The SOAH Administrative Law judges determined that the most appropriate location for these cases is the TDWC.

A petition asking the Texas Supreme Court to review the Third Court of Appeals decision has been denied. Therefore, the Company is bound by the Third Court of Appeals decision. The Texas Supreme Court's decision delayed final adjudication in these pending stop-loss cases. The uncertain outcome in these cases will depend on a very lengthy process. We anticipate further, lengthy litigation at the Travis County District Courts and the Texas Courts of Appeals. Because of this lengthy process and the uncertainty of recovery in these cases, collection of a material amount of funds in these pending stop-loss cases cannot be anticipated.

Through November 2013, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately $11 million in claims. In most of these cases, when the payments were made, the carriers requested refunds of the payments made in the event that the SOAH decisions and orders were reversed on appeal (which they were). Our request that the TDWC Commissioner enforce the awards which were not voluntarily paid by the carriers was refused in approximately 130 cases. As a result of the reversal of the SOAH decisions and orders, Texas Mutual Insurance Company and other carriers filed petitions in Travis County district court seeking a refund in cases in which the awards were voluntarily paid. The district court found in favor of Texas Mutual and the Company was ordered to refund approximately $4.2 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. The Company did not object to the reversal and remand of the SOAH decisions and orders, but did object to the judgments ordering refunds and those judgments were appealed to the Third Court of Appeals. As part of the appeals, the Company deposited the amounts that were ordered to be refunded as cash deposits into the registry of the court in order to stay execution of the judgments ordering refunds. On June 6, 2013, the judgments ordering refunds were reversed by the Court of Appeals. The Court of Appeals held that if Texas Mutual wants a refund, it must pursue the refund demand administratively through the TDWC rather than through the district courts. Texas Mutual filed a motion for rehearing with the Court of Appeals which ultimately was denied. The Company has filed motions in all 47 cases with the district court asking that the district clerk be ordered to release the deposited funds to the Company. On December 16, 2013, orders directing the district clerk to disburse the funds were presented to the district court. These orders were signed, and in January 2014, the Company received the deposits and accrued interest. In addition, Texas Mutual filed three additional petitions in district court for cases that were left out of the original 47. The court granted Texas Mutual's petitions and ordered the Company to refund approximately $300,000, including prejudgment interest to Texas Mutual. These judgments were granted before the Court of Appeals reversed the district court's original judgments. These three cases have been appealed to the Court of Appeals and the funds ordered refunded have been deposited with the district clerk. The Court of Appeals has reversed the district court's final judgments in these three cases and the Company has filed motions with the district court asking that the district clerk be ordered to release the deposited funds to the Company. During the time that the carriers' petitions seeking refunds were pending, because of the uncertainty of the results at that time, as of November 30, 2013, the Company has accrued the total potential refund amount of $7.8 million, and an additional amount of $2.3 million in interest payable, as accrued liabilities. We do not anticipate that any other carriers will pursue refund demands through district court but instead will pursue them administratively through TDWC. The cases in which the SOAH decisions and orders were reversed have been or are being remanded to TDWC for determinations of whether the services provided were unusually costly and unusually extensive. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and may be ordered to be refunded. After the reversal of the judgments it obtained from the district court ordering refunds, on December 4, 2013, Texas Mutual made a formal request to the Commissioner of Workers' Compensation that he administratively order the Company to make refunds to Texas Mutual (in the same amount that was sought in the district court). The Company responded to this request on December 11, 2013, asking that it be denied. The matter is pending at this time. As to the matters remanded to TDWC and SOAH, once the Company is given the opportunity to present its evidence regarding whether the services provided were unusually costly and unusually extensive, the Company anticipates that it will prevail in many of the underlying stop-loss fee disputes and that payments refunded to the carriers will be recaptured.

Due to the uncertainties associated with these stop-loss fee dispute cases, the Company recognized increases in the contractual allowance at our Pasadena facility of $10,254,990 during fiscal year 2011 and $149,875 during the fiscal quarter ended August 31, 2013, (and an additional contractual allowance amount of $779,583 during fiscal year 2011 and $136,542 during the fiscal quarter ended August 31, 2013, at our Garland facility, which was classified as discontinued operations). The Company has also recognized interest expense related to these refunds starting from fiscal year 2011.

Claims regarding payment for ambulatory surgical center and hospital outpatient services remain pending at the TDWC. It is expected that these claims will be adjudicated at SOAH and possibly in the Texas district and appellate courts. The basis for reimbursement for these services made the subject of these pending cases is the determination of "fair and reasonable" charges. In 2007, we received unfavorable rulings from SOAH in all of our appeals of unfavorable decisions related to services provided in 2001 and 2002. The 179 cases, which were appealed to the Travis County district courts, challenged the constitutionality of the relevant statutory language. The Company received an unfavorable ruling in its lead case in March 2009, which ruling was appealed to and was upheld by the Third Court of Appeals on August 26, 2010. The Texas Supreme Court denied a petition asking for review of the Third Court of Appeals decision. The unfavorable interpretation by the Texas Courts of Appeal in our lead case negatively affects the recovery of additional reimbursement, not only in the lead case, but in the remaining 178 pending cases. Consequently, the Company is bound by the Third Court of Appeals' ruling that interprets the applicable statute and fee guideline to require that the amount that will be paid to a provider must not only be at a "fair and reasonable rate" but also must "ensure the quality of medical care" and "achieve effective cost control" and be the same or less than that charged to others with an equivalent standard of living. This ruling will impact cases in which a fee guideline was not applicable, specifically all pending cases involving ambulatory surgical services provided from 2001 through 2004 as well as all pending cases involving hospital outpatient services provided prior to March 1, 2008, when the Guidelines took effect. Since the Third Court of Appeals' unfavorable ruling, collection, if any, in these cases depends on the Company's ability to establish the criteria in this ruling. The Company was given the opportunity to establish the criteria in approximately 80 cases, which were set for hearing on the merits from March through May 2012 and was unsuccessful. Additionally, there are several thousand ambulatory surgical center and hospital outpatient cases pending at SOAH which will be heard beginning in March, 2014. Settlement offers have been made in the vast majority of these cases and the Company has been successful in settling many of the cases in which offers were made. Even so, it is likely that hundreds, if not more than a thousand, of these cases may go to hearing at SOAH at which the Company will have the opportunity to continue to establish the criteria in the cases still pending at SOAH during the 2014 fiscal year.

Due to the uncertainties regarding the accounts receivable in the MDR process, the 2008 and 2010 Third Court of Appeals' opinions and our legal counsel's advice that settlements with insurance carriers in stop-loss cases have virtually stopped, the Company had fully reserved all accounts receivable related to the MDR process as of August 31, 2008. The Company is in active settlement negotiations with insurance carriers for ambulatory surgical center and hospital outpatient cases. Any monies collected for these MDR accounts receivable will be recorded as current period's net patient service revenues.

Provision for Doubtful Accounts

Although outcomes vary, our policy is to attempt to collect amounts due from patients, including co-payments and deductibles due from patients with insurance, at the time of service while complying with all federal and state laws and regulations. In non-emergency circumstances or for elective procedures and services, it is our policy to verify insurance prior to a patient being treated; however, there are various exceptions that can occur.

The Company computes its allowances based on the estimated collections on its gross billed charges. The Company computes its estimate of allowance, which is a combination of contractual allowance and provision for doubtful accounts, by taking into account collections received, up to 30 days after the end of the period, for the services performed and also estimating amounts collectible for the services performed within the last six months.

Accounts receivable represent net receivables for services provided by the Company. At each balance sheet date management reviews the accounts receivable for collectibility and provides full allowance reserves for any accounts receivable deemed uncollectible.

The allowances stated as a percentage of gross receivables at the balance sheet dates is larger than the allowance percentage used to reduce gross billed charges due to the application of partial cash collections to the outstanding gross receivable balances, without any adjustment being made to the allowances. The allowance amounts netted against gross receivables are not adjusted until such time as the final collections on an individual receivable are recognized.

The focal point of our business is providing patient care services, including complex orthopedic and bariatric procedures. The Company pursues optimal reimbursement from third-party payers for these services. In some instances, we do not have contractual arrangements with third-party payers which provide for “prompt payment” which may result in additional time to collect the expected reimbursement.

The collection process may also be extended due to our efforts to obtain all optimal reimbursement available to the Company. Specifically, for medical services provided to injured workers, the Company may initially receive reimbursement that may not be within the fee guidelines or regulatory guidelines mandating reimbursement. The Company reviews and pursues those particular claims that are determined to warrant additional reimbursement pursuant to the fee or regulatory guidelines. The Company's pursuit of additional reimbursement amounts that it believes are due under fee or regulatory guidelines may be accomplished through established dispute resolution procedures with applicable regulatory authorities.

Noncontrolling Interest

The equity of minority investors (minority investors are generally physician groups and other healthcare providers that perform surgeries at the Company’s facilities) in certain subsidiaries of the Company is reported on the consolidated balance sheets as noncontrolling interest. Noncontrolling interest reported in the consolidated income statements reflect the respective interests in the income or loss of the limited partnerships or limited liability companies attributable to the minority investors (equity interest ranged from 1.75% to 2.00% at November 30, 2013).

Other Comprehensive Income (Loss)

The changes in accumulated other comprehensive income (loss) by component (net of tax) is as follows:

Three months ended November 30, 2013
Accumulated Other Comprehensive
Income (For Changes in Fair Value

	of Available-for-Sale Securities)
Balance as of August 31, 2013	$ 9,382,334
Other comprehensive income before reclassifications	1,820,916
Amounts reclassified from accumulated other comprehensive income	
Net current-period other comprehensive income	1,820,916
Balance as of November 30, 2013	$ 11,203,250

15

	Three months ended November 30, 2012 Change in Foreign Currency Translation Adjustment	Change in Fair Value of Available-for-Sale Securities	Accumulated Other Comprehensive Income (Loss)
Balance as of August 31, 2012	$ 8,196	$ 8,411,128	$ 8,419,324
Other comprehensive income before reclassifications		1,199,005	1,199,005
Amounts reclassified from accumulated other comprehensive income	(8,196)	(2,199,500)	(2,207,696)
Net current-period other comprehensive loss	(8,196)	(1,000,495)	(1,008,691)
Balance as of November 30, 2012	$	$ 7,410,633	$ 7,410,633

The following table presents a subtotal for each significant reclassification to net income out of accumulated other comprehensive income (loss) and the line item affected in the consolidated statement of operations during the three months ended November 30, 2012:

Details about accumulated other comprehensive income (loss) components	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where net income is presented
Gain on foreign currency translation adjustment	$ 12,610	Rent and other income
Tax provision	(4,414)	Accrued liabilities
	$ 8,196	
Gain on call of available for sale securities	$ 2,199,500	Rent and other income
Tax provision		
	$ 2,199,500	

Contingencies

Due to the uncertainties associated with the stop-loss fee dispute cases, the Company has accrued an amount of $7.8 million, and an additional amount of $2.3 million in interest payable, as accrued liabilities. For a detailed discussion of this, see Revenue Recognition Policy under Notes to Consolidated Financial Statements.

The Company maintains various insurance policies that cover its Pasadena facility including occurrence medical malpractice coverage. In addition, all physicians granted privileges at the Pasadena facility are required to maintain medical malpractice insurance coverage. The Company also maintains general liability and property insurance coverage, including flood coverage. The Company does not currently maintain workers' compensation coverage in Texas. In regard to the Employee Health Insurance Plan, the Company is self-insured with specific and aggregate re-insurance with stop-loss levels appropriate for the Company's group size. Coverage is maintained in amounts management deems adequate.

We do not carry director and officer liability insurance. As permitted under Nevada law and pursuant to our governing documents and indemnification agreements with certain of our officers and directors, we indemnify our directors and officers against monetary damages, including advancing expenses, to the fullest extent permitted by Nevada law.

On May 21, 2013, Ping S. Chu and James G. Gerace (both former members of our Board of Directors), along with seven other plaintiffs, filed a lawsuit in Probate Court No. 3 of Harris County, Texas, naming as defendants Ella Y.T.C. Chan (in her individual capacity and in her capacity as Independent Executrix of the Estate of Chiu M. Chan, Deceased, our former Chief Executive Officer and director), Eric K. Chan (our current Chief Executive Officer and director), and Dynacq Healthcare, Inc. In the suit, the plaintiffs alleged that the Chan family had received improper financial benefits from us. The plaintiffs sought damages in connection with claims of breach of fiduciary duty, shareholder oppression, constructive trust and conspiracy. We, through our legal counsel, filed an answer to the original petition, and filed a motion with the Probate Court to dismiss the lawsuit. The Probate Court granted the motion and dismissed the lawsuit. On August 19, 2013, the same lawsuit was re-filed in the 151st District Court of Harris County, Texas, in the form of a counterclaim and third party intervention in a lawsuit previously filed by Ella Chan (as Executrix of the Estate of Chiu M. Chan) against Ping Chu for the return of a personal automobile of Chiu M. Chan. An additional party has joined in the counterclaim and intervention. We believe the counterclaim and intervention are without merit and intend to vigorously defend ourselves in the suit.

16

The Company is routinely involved in litigation and administrative proceedings that are incidental to its business. Specifically, all judicial review of unsatisfactory determinations of reimbursement amounts due us for our Texas facilities' fees must be made in the district courts of Travis County, Texas in what can often be a lengthy procedure.

Recent Accounting Pronouncements

No recent accounting pronouncements or other authoritative guidance has been issued that management considers likely to have a material impact on our consolidated financial statements.

Industry Segments and Geographic Information

The Industry Segment "U.S. Division" comprises of the Company's Pasadena facility. The Company at the present time has the U.S. Division and the Corporate Division.

Certain previously reported financial information has been reclassified to conform to the current period's presentation.

Corporate Division

The Company closed the Garland facility on September 30, 2011, and sold it in July 2013. The Company took an impairment charge of approximately $1.1 million during the three months ended August 31, 2012, based on the sales price negotiated at that time. An additional loss of $122,975 was taken based on the final sales price during the three months ended August 31, 2013.

The Company organized Sino Bond to hold and manage investments in Hong Kong. Sino Bond invests in debt instruments (corporate and municipal) and equity securities in Europe and Asia, including initial public offerings and pre-initial public offerings. The Company invests in various marketable securities. During the three months ended November 30, 2012, one particular security was called on which the Company had a gain of approximately $2.2 million. As of November 30, 2013, the balance of these securities is valued at approximately $19.3 million. During the three months ended November 30, 2013 and 2012, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had a net gain of $161,864 and $58,378, respectively. During the current period, the Company sold all of its trading securities and does not hold any such security as of November 30, 2013.

The Corporate Division includes interest and other income related to its investments in securities, corporate personnel compensation expenses, and general and administrative expenses. Such expenses and income are not allocated to our operating division, as they relate to our general corporate activities.

We generally evaluate performance based on profit or loss from operations before income taxes and non-recurring charges and other criteria. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. There are no transfers between segments.

Summarized financial information concerning the business segments from continuing operations is as follows:

	Three Months Ended November 30, 2013		2012	
Revenues from external customers				
Net patient service revenues				
U.S. Division	$	2,259,247	$	1,518,027
Corporate				
Consolidated	$	2,259,247	$	1,518,027
Income (loss) before taxes and discontinued operations				
U.S. Division	$	(377,958)	$	(700,508)
Corporate		(330,903)		870,812
Consolidated	$	(708,861)	$	170,304

	November 30, 2013		August 31, 2013	
Total Assets				
U.S. Division	$	10,597,756	$	9,924,501
Corporate		32,274,388		31,711,826
Consolidated	$	42,872,144	$	41,636,327

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

This quarterly report on Form 10-Q contains forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expects,” “intends,” “plans,” “anticipates,” “b “estimates,” “predicts,” “potential,” or the negative of these terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially. Such forward-looking statements relate to future events or future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our Company’s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements, including the risks and uncertainties described in “Risk Factors” in our annual report on Form 10-K for the fiscal year ended August 31, 2013. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. You must read the following discussion of the results of our business and our operations and financial condition in conjunction with our consolidated financial statements, including the notes, included in this quarterly report on Form 10-Q and our audited consolidated financial statements, including the notes, included in our Annual Report on Form 10-K for the fiscal year ended August 31, 2013.

Update on Critical Accounting Policies and Estimates

There have been no changes to the critical accounting policies used in our reporting of results of operations and financial position for the three months ended November 30, 2013. For a discussion of our critical accounting policies see Management's Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the fiscal year ended August 31, 2013.

Results of Operations

	Three Months Ended November 30, 2013			Three Months Ended November 30, 2012		
	U.S. Division	Corporate	Total	U.S. Division	Corporate	Total
Net patient service revenue	$ 2,259,247	$	$ 2,259,247	$ 1,518,027	$	$ 1,518,027
Costs and expenses:						
Compensation and benefits	942,566	509,201	1,451,767	892,287	496,537	1,388,824
Medical services and supplies	617,470		617,470	395,540		395,540
Other operating expenses	836,423	276,055	1,112,478	726,940	1,845,311	2,572,251
Depreciation and amortization	107,307	1,002	108,309	112,241	11,511	123,752
Total costs and expenses	2,503,766	786,258	3,290,024	2,127,008	2,353,359	4,480,367
Operating loss	(244,519)	(786,258)	(1,030,777)	(608,981)	(2,353,359)	(2,962,340)
Other income (expense):						
Rent and other income	9,844	265,701	275,545	48,453	2,920,638	2,969,091
Interest income		202,323	202,323		304,814	304,814
Interest expense	(143,283)	(12,669)	(155,952)	(139,980)	(1,281)	(141,261)
Total other income (expense), net	(133,439)	455,355	321,916	(91,527)	3,224,171	3,132,644
Income (loss) before income taxes from continuing operations	$ (377,958)	$ (330,903)	(708,861)	$ (700,508)	$ 870,812	170,304
Provision (benefit) for income taxes						
Income (loss) from continuing operations			(708,861)			170,304
Discontinued operations, net of income taxes						241,358
Net income (loss)			(708,861)			411,662
Less: Net loss attributable to noncontrolling interest			26			2,798
Net income (loss) attributable to Dynacq Healthcare, Inc.			$ (708,835)			$ 414,460
Operational statistics (Number of medical procedures) for Pasadena facility:						
Inpatient:						
Bariatric	20			10		
Orthopedic	13			2		
Other	5			12		
Total inpatient procedures	38			24		

Outpatient:		
Orthopedic	64	34
Other	139	145
Total outpatient procedures	203	179
Total procedures	241	203

19

Three Months Ended November 30, 2013 Compared to the Three Months Ended November 30, 2012

U.S. Division

Through November 2013, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately $11 million in claims. In most of these cases, when the payments were made, the carriers requested refunds of the payments made in the event that the SOAH decisions and orders were reversed on appeal (which they were). Our request that the TDWC Commissioner enforce the awards which were not voluntarily paid by the carriers was refused in approximately 130 cases. As a result of the reversal of the SOAH decisions and orders, Texas Mutual Insurance Company and other carriers filed petitions in Travis County district court seeking a refund in cases in which the awards were voluntarily paid. The district court found in favor of Texas Mutual and the Company was ordered to refund approximately $4.2 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. The Company did not object to the reversal and remand of the SOAH decisions and orders, but did object to the judgments ordering refunds and those judgments were appealed to the Third Court of Appeals. As part of the appeals, the Company deposited the amounts that were ordered to be refunded as cash deposits into the registry of the court in order to stay execution of the judgments ordering refunds. On June 6, 2013, the judgments ordering refunds were reversed by the Court of Appeals. The Court of Appeals held that if Texas Mutual wants a refund, it must pursue the refund demand administratively through the TDWC rather than through the district courts. Texas Mutual filed a motion for rehearing with the Court of Appeals which ultimately was denied. The Company has filed motions in all 47 cases with the district court asking that the district clerk be ordered to release the deposited funds to the Company. On December 16, 2013, orders directing the district clerk to disburse the funds were presented to the district court. These orders were signed, and in January 2014, the Company received the deposits and accrued interest. In addition, Texas Mutual filed three additional petitions in district court for cases that were left out of the original 47. The court granted Texas Mutual's petitions and ordered the Company to refund approximately $300,000, including prejudgment interest to Texas Mutual. These judgments were granted before the Court of Appeals reversed the district court's original judgments. These three cases have been appealed to the Court of Appeals and the funds ordered refunded have been deposited with the district clerk. The Court of Appeals has reversed the district court's final judgments in these three cases and the Company has filed motions with the district court asking that the district clerk be ordered to release the deposited funds to the Company. During the time that the carriers' petitions seeking refunds were pending, because of the uncertainty of the results at that time, as of November 30, 2013, the Company has accrued the total potential refund amount of $7.8 million, and an additional amount of $2.3 million in interest payable, as accrued liabilities. We do not anticipate that any other carriers will pursue refund demands through district court but instead will pursue them administratively through TDWC. The cases in which the SOAH decisions and orders were reversed have been or are being remanded to TDWC for determinations of whether the services provided were unusually costly and unusually extensive. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and may be ordered to be refunded. After the reversal of the judgments it obtained from the district court ordering refunds, on December 4, 2013, Texas Mutual made a formal request to the Commissioner of Workers' Compensation that he administratively order the Company to make refunds to Texas Mutual (in the same amount that was sought in the district court). The Company responded to this request on December 11, 2013, asking that it be denied. The matter is pending at this time. As to the matters remanded to TDWC and SOAH, once the Company is given the opportunity to present its evidence regarding whether the services provided were unusually costly and unusually extensive, the Company anticipates that it will prevail in many of the underlying stop-loss fee disputes and that payments refunded to the carriers will be recaptured.

Net patient service revenue increased by $741,220, or 49%, from $1,518,027 to $2,259,247, and total surgical cases increased by 19% from 203 cases for the three months ended November 30, 2012 to 241 cases for the three months ended November 30, 2013. While the number of cases increased by 19%, net patient service revenue increased by 49%, primarily due to a change in the surgical mix of cases.

Total costs and expenses increased by $376,758, or 18%, from $2,127,008 for the three months ended November 30, 2012 to $2,503,766 for the three months ended November 30, 2013. The following discusses the various changes in costs and expenses:

· Compensation and benefits increased by $50,279, or 6%, primarily associated with increase in workforce due to higher net patient service revenues.

· Medical services and supplies expenses increased by $221,930, or 56%, primarily due to a 19% increase in the number of cases, and also due to a change in the surgical mix of cases. The gross billed charges increased by 52%.

· Other operating expenses increased by $109,483, or 15%, primarily associated with higher net patient service revenues.

Other expense for the three months ended November 30, 2013 and 2012 of $133,439 and $91,527, respectively, includes interest expense associated with the stop-loss cases discussed above.

Corporate Division

Compensation and benefits for the Corporate Division includes all corporate personnel compensation and benefits. It also includes $49,341 and $(33,547) of non-cash compensation expense for the three months ended November 30, 2013 and 2012, respectively, related to employees' incentive stock options granted in fiscal years 2007, 2011 and 2012. The negative expense during the three months ended November 30, 2012 is the result of reversal of expenses for forfeiture of the unvested stock options. Apart from the stock option expense discussed above, the decrease in 2013, compared to 2012, of 13% is primarily due to a reduction in corporate staff.

Other operating expenses include all corporate general and administrative expenses, including other professional fees such as legal expenses and audit expenses. It decreased by $1,569,256, from $1,845,311 for the three months ended November 30, 2012 to $276,055 for the three months ended November 30, 2013. The decrease in other operating expenses is due to a significant decrease in legal and other professional fees by approximately $1,312,000 primarily for the internal investigation discussed in note 12 to our consolidated financial statements for the fiscal year ended August 31, 2013.

Rent and other income decreased by $2,654,937, from $2,920,638 for the three months ended November 30, 2012 to $265,701 for the three months ended November 30, 2013. Rent and other income for the three months ended November 30, 2013 includes (a) an amount of $73,475 in foreign currency gains, (b) a gain of $161,864 in trading securities, and (e) miscellaneous other income of $30,362. Rent and other income for the three months ended November 30, 2012 includes (a) a gain of $2,199,500 on a bond called during the period, (b) a gain of $480,108 on the sale of the apartment in Hong Kong, (c) an amount of $139,280 in foreign currency gains, (d) a gain of $58,378 in trading securities, and (e) miscellaneous other income of $43,372.

Interest income of $202,323 and $304,814 for the three months ended November 30, 2013 and 2012, respectively, are primarily related to the Company's investments in bonds.

Investments in securities

The Company's investments in debt instruments (corporate and municipal bonds) are recorded at fair value based on quoted market prices that are traded in less active markets or priced using a quoted market price for similar investments or are priced using non-binding market consensus prices that can be corroborated by observable market data (Level 2). These investments are classified as available-for-sale securities. As of November 30, 2013, these securities are valued at approximately $19.3 million. Unrealized gains in these investments of $11.2 million are included in accumulated other comprehensive income in the Consolidated Balance Sheet as at November 30, 2013. During the three months ended November 30, 2013 and 2012, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had gains of $161,864 and $58,378, respectively. During the current period, the Company sold all of its trading securities and does not hold any such securities as of November 30, 2013.

Discontinued Operations

The Company closed the Garland facility on September 30, 2011, and sold it in July 2013. The Company took an impairment charge of approximately $1.1 million during the three months ended August 31, 2012, based on the sales price negotiated at that time. An additional loss of $122,975 was taken based on the final sales price during the three months ended August 31, 2013. Net patient service revenue for the three months ended November 30, 2012 was $210,825, due to receipts on old accounts receivable that were fully reserved earlier per the Company's revenue recognition policy.

Income Taxes

The Company did not recognize a benefit or provision for income taxes for the three months ended November 30, 2013, due to the uncertainty of the Company's ability to recognize the benefit from the carry forward of net operating losses. The Company has recorded a full valuation allowance against the deferred tax asset. For the three months ended November 30, 2012, the Company did not recognize any provision for income taxes since the Company anticipated to incur a loss for the fiscal year ended August 31, 2013, and it also had net operating loss carry forward.

Liquidity and Capital Resources

Our fiscal year 2013 Annual Report on Form 10-K includes a detailed discussion of our liquidity, contractual obligations and commitments. The information presented below updates and should be read in conjunction with the information disclosed in that Form 10-K.

Cash flow from operating activities

Cash flow used in operating activities for continuing activities was $1,275,281 during the three months ended November 30, 2013, primarily due to (a) a net loss before discontinued operations of $708,861, (b) an increase in accounts receivable of $618,673, and (c) a gain of $161,864 in trading securities. Partially offsetting these cash outflows were (a) depreciation and amortization of $108,309, and (b) an increase in accounts payable and accrued liabilities of $115,517.

Cash flows from investing activities

Cash flow provided by investing activities for continuing activities was $1,209,798, primarily due to sales proceeds of $1,233,286 in trading securities.

Cash flows from financing activities

Cash flow used in financing activities for continuing activities was $41,097 for payments on capital leases and notes payable.

The Company had working capital of $3,204,679 as of November 30, 2013 and maintained a liquid position by a current ratio of approximately 1.2 to 1.

We believe we will be able to meet our ongoing liquidity and cash needs for at least the next twelve months based on the amount of available cash and cash equivalents.

Recent Accounting Pronouncements

See notes to the Consolidated Financial Statements - Recent Accounting Pronouncements, which is incorporated here by reference.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Not required.

Item 4. Controls and Procedures.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation to assess the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, pursuant to Exchange Act Rule 13a-15(e). Based on that evaluation, our principal executive officer and principal financial officer concluded that, as of November 30, 2013, our disclosure controls and procedures were effective.

Changes in Internal Control over Financial Reporting.

There have been no significant changes in our internal control over financial reporting during the most recently completed fiscal quarter or in other factors that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

22

Our management, including our principal executive officer and principal financial officer, does not expect that our disclosure controls or internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of error of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by management's override of the control. The design of any systems of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of these inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

On May 21, 2013, Ping S. Chu and James G. Gerace (both former members of our Board of Directors), along with seven other plaintiffs, filed a lawsuit in Probate Court No. 3 of Harris County, Texas, naming as defendants Ella Y.T.C. Chan (in her individual capacity and in her capacity as Independent Executrix of the Estate of Chiu M. Chan, Deceased, our former Chief Executive Officer and director), Eric K. Chan (our current Chief Executive Officer and director), and Dynacq Healthcare, Inc. In the suit, the plaintiffs alleged that the Chan family had received improper financial benefits from us. The plaintiffs sought damages in connection with claims of breach of fiduciary duty, shareholder oppression, constructive trust and conspiracy. We, through our legal counsel, filed an answer to the original petition, and filed a motion with the Probate Court to dismiss the lawsuit. The Probate Court granted the motion and dismissed the lawsuit. On August 19, 2013, the same lawsuit was refiled in the 151st District Court of Harris County, Texas, in the form of a counterclaim and third party intervention in a lawsuit previously filed by Ella Chan (as Executrix of the Estate of Chiu M. Chan) against Ping Chu for the return of a personal automobile of Chiu M. Chan. An additional party has joined in the counterclaim and intervention. We believe the counterclaim and intervention are without merit and intend to vigorously defend ourselves in the suit.

The Company is routinely involved in litigation and administrative proceedings that are incidental to its business. Specifically, all judicial review of unsatisfactory determinations of reimbursement amounts due us for our Texas facilities' fees must be made in the district courts of Travis County, Texas in what can often be a lengthy procedure. Please refer to Revenue Recognition, as well as Business Government Regulation Texas Workers' Compensation Systems in our Form 10-K for the fiscal year ended August 31, 2013, for a detailed description of the MDR process and our accounts receivable. The Company cannot predict whether any litigation or administrative proceeding to which it may become a party will have a material adverse effect on the Company's results of operations, cash flows or financial condition.

Item 1A. Risk Factors.

The Company's Risk Factors as disclosed in its Form 10-K for the year ended August 31, 2013 have not materially changed.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

In September 2013, as part of a settlement agreement with a former employee, the Company received 125,000 shares of common stock of the Company previously issued to him. These shares have been accounted for as treasury shares with zero cost.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

EXHIBIT NO.	IDENTIFICATION OF EXHIBIT
Exhibit 31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
**101.INS	XBRL Instance Document.
** 101.SCH	XBRL Taxonomy Extension Schema Document.
**101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
**101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
**101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
**101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

SIGNATURES

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

DYNACQ HEALTHCARE, INC.

Date: January 14, 2014	By:	/s/ Eric K. Chan Eric K. Chan Chief Executive Officer (duly authorized officer)
Date: January 14, 2014	By:	/s/ Hemant Khemka Hemant Khemka Chief Financial Officer (principal financial and accounting officer)

25

INDEX OF EXHIBITS

EXHIBIT NO.	IDENTIFICATION OF EXHIBIT
Exhibit 31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
**101.INS	XBRL Instance Document.
** 101.SCH	XBRL Taxonomy Extension Schema Document.
**101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
**101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
**101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
**101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.