DYNACQ HEALTHCARE INC
Form 10-K
November 21, 2006
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# U.S. SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-K

x **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the fiscal year ended August 31, 2006**

¨ **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)**

| **Delaware** | **76-0375477** |
|---|---|
| **(State or Other Jurisdiction of Incorporation or Organization)** | **(I.R.S. Employer Identification No.)** |

| **10304 Interstate 10 East, Suite 369, Houston, Texas** | **77029** |
|---|---|
| **(Address of Principal Executive Offices)** | **(Zip Code)** |

**Registrant s telephone number, including area code: (713) 378-2000**

**Securities registered pursuant to Section 12(b) of the Exchange Act: None**

**Securities registered pursuant to Section 12(g) of the Exchange Act:**

| Title of each class | Name of each exchange on which registered |
|---|---|
| **Common Stock, $0.001 Par Value** | **NASDAQ** |

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One): Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

The aggregate market value of voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of February 28, 2006 was $18,626,110. As of November 13, 2006, the registrant had 15,740,711 shares of common stock outstanding.

**Documents Incorporated by Reference:**

Portions of the definitive proxy statement relating to the 2006 Annual Meeting of Shareholders of the Company, which will be filed with the Commission by December 29, 2006, are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this Form 10-K.

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**PART I**

This annual report on Form 10-K contains forward-looking statements regarding future events and our future financial performance. Words such as expects, intends, forecasts, projects, plans, anticipates, believes, estimates, predicts, potential and similar expressions ident statements within the meaning of the Private Securities Litigation Reform Act. All forward-looking statements are based on our current beliefs as well as assumptions made by and information currently available to us. These statements reflect our current views with respect to future events. Important factors that could cause actual results to materially differ from our current expectations include the risks and uncertainties described in Item 1A. Risk Factors below. Please read the following discussion of the results of our business and our operations and financial condition and the risk factors along with our consolidated financial statements, including the notes, included in this annual report on Form 10-K.

**Item 1. Business.**

**General**

Dynacq Healthcare, Inc., a Delaware corporation, is a holding company that through its subsidiaries develops and manages general acute care hospitals that principally provide specialized surgeries. The Company s business strategy is to develop and operate general acute care hospitals designed to handle specialized surgeries such as bariatric, orthopedic and neuro-spine surgeries. Certain of the Company s facilities also provide fertility, sleep laboratory and pain management services, as well as minor emergency treatment services and ear, nose and throat services. The Company s hospitals include operating rooms, pre- and post-operative space, intensive care units, nursing units and diagnostic facilities, as well as adjacent medical office buildings that lease space to physicians and other healthcare providers. These hospitals are the Vista Medical Center Hospital in Pasadena, Texas, near Houston (the Pasadena Facility ); Vista Hospital of Dallas (the Garland Facility ); Vista Surgical Hospital of Baton Rouge (the Baton Rouge Facility ); and an outpatient surgery center, Vista Surgical Center West (the West Houston Facility ).

The Company owns a 70% equity interest in Shanghai DeAn Hospital, a joint venture formed under the laws of the People s Republic of China (the DeAn Joint Venture ). On May 16, 2005, the DeAn Joint Venture entered into land use agreements with the Chinese Government, under which it leased, for a term of 50 years, approximately 28.88 acres of government-owned land in Shanghai, China on which a hospital will be constructed to be owned and operated by the DeAn Joint Venture. Work on clearing and preparing the land for construction including constructing a peripheral wall, commenced in October 2005. The DeAn Joint Venture is currently negotiating a contract for the construction of the hospital, referred to herein as the China Project .

Except for emergency room patients, surgeries at our facilities are typically pre-certified or pre-authorized by the insurance carriers. The bulk of the surgeries are either covered by workers compensation insurance or by commercial insurers on an out-of-network health plan basis. Historically the Company has not participated in managed care contracts and has not received a substantial amount of reimbursement from Medicare or Medicaid. However, during the first quarter of fiscal 2006, the Company began participation in certain managed care contracts and anticipates entering into additional contracts in the future. To date these contracts have not resulted in any meaningful patient revenues.

The Company, through its affiliates, owns or leases 100% of the real estate for and equipment in its facilities. The Company maintains a majority ownership and controlling interest in all of its operating entities. As of August 31, 2006, the Company owned the following percentages of its operating entities, with the remaining percentages owned by physicians and other healthcare professionals:

| | |
|---|---|
| Pasadena Facility | 98.5% |
| Garland Facility | 97% |
| Baton Rouge Facility[(1)] | 90% |
| West Houston Facility[(1)] | 100% |

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(1) The assets related to these facilities have been shown as Assets held for sale and the operations classified as discontinued operations in the accompanying financial statements. However, the facilities continue to be operated by the Company until such time as they are sold.

The Company was incorporated in Nevada in February 1992. In November 2003, the Company reincorporated in Delaware and changed its name from Dynacq International, Inc. to Dynacq Healthcare, Inc. The terms Company, Dynacq, our or we are used herein to refer to Dynacq Healthcare, Inc. and its affiliates unless otherwise stated or indicated by context. The term affiliates means direct and indirect subsidiaries of Dynacq Healthcare, Inc. and partnerships and joint ventures in which subsidiaries are general or limited partners or members.

**Recent Developments**

*Assets held for Sale*

In 2006, the Company made the decision to sell the assets related to its Baton Rouge and West Houston Facilities. On February 21, 2006, the Company entered into an agreement to sell the Baton Rouge Facility, but the transaction was not consummated and the sales agreement terminated on March 7, 2006. The Company is in the process of retaining the services of brokers to locate buyers for the Baton Rouge and West Houston Facilities and its land in The Woodlands, Texas, and will continue to pursue sales opportunities for those properties. The assets related to these facilities have been classified as Assets held for sale . None of these assets is encumbered by secured lien or debt, so all proceeds from the sale of any of those assets, net of selling expenses, would be available to the Company to pursue its business plans, including the China Project.

*Changes to the Texas Workers Compensation System*

The 2005 Texas Legislature substantially revised the workers compensation system. One of the significant changes to the system is the implementation of workers compensation healthcare networks, which are packaged groups of healthcare providers that an employer or insurance carrier may contract with for the provision of health care services to injured workers. An employer and carrier s participation in a network is discretionary, but if they choose to utilize a network, employees will be required to seek healthcare from a network healthcare provider. The Texas Division of Workers Compensation (formerly the Texas Worker s Compensation Commission and referred to herein as the TDWC) has adopted rules implementing healthcare networks.

Following the recent procedural changes implemented by the TDWC on September 1, 2005 regarding appeals in the Medical Dispute Resolution ( MDR ) process, the Company has sought judicial review of TDWC s decisions regarding reimbursement for inpatient and outpatient surgical services at both the administrative level at the State Office of Administrative Hearings ( SOAH ) and at the district court level in the Travis County District Courts. However, these procedural changes, coupled with the uncertainty created by the lack of an accepted interpretation of the stop-loss methodology, have prevented many, if not all, of the stop-loss cases at all levels of the MDR process from moving forward.

However, in July of 2006, the en banc panel which presides over the Consolidated Stop-Loss Docket at SOAH and which consists of nine administrative law judges, issued a schedule establishing deadlines for both the carriers and the providers to submit briefs regarding the stop-loss issue and for scheduling oral argument. The carriers and the providers submitted their respective briefs, and on November 3, 2006 the en banc panel heard the arguments of both the carriers and providers, but has not issued a decision regarding the stop-loss issue. Inpatient stop-loss cases pending at SOAH and in the Travis County District Courts are currently awaiting a decision by the en banc panel and final interpretation of the stop-loss methodology. The Travis County District Court has suggested that it will wait for a decision at SOAH regarding the stop-loss issue.

The MDR process, as it relates to the Company s outpatient surgical services disputes, has made significant progress in the last 90 days. These cases have been divided into four consolidated dockets, one of which is in the beginning stages of an expedited discovery period, culminating in the scheduling of trial as early as mid-January 2007 for cases with dates of service from 2001-2002.

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See Government Regulation for additional information.

*Private Placement*

In May 2006, the Company offered for sale shares of its common stock to a limited number of accredited investors in a private placement at a purchase price of $1.54 per share, which was 70% of the market price of Company stock on the offering date. A total of 889,143 shares were sold, resulting in sales proceeds of $1,369,280. The shares are restricted securities which may not be offered or sold publicly in the United States except pursuant to the effectiveness of a registration statement or an applicable exemption from the registration requirements of the Securities Act. The sales proceeds were used to meet the cash needs of the Company s day-to-day operations.

*Bariatric Program for Pasadena, Garland and Baton Rouge Facilities*

New bariatric or weight control programs were implemented at the Pasadena and Baton Rouge Facilities in the first quarter of fiscal 2006 and at the Garland Facility in the second quarter of fiscal 2006, to replace the former bariatric programs at those facilities and to reduce costs associated with outside vendor programs. Our programs provide or contract for marketing, pre-authorization and follow up support services to prospective bariatric patients in areas serviced by the Pasadena, Garland or Baton Rouge Facilities. The new bariatric programs have resulted in some bariatric cases, however, the programs are still in the early stages of development, and the number of cases generated will have to improve substantially for such programs to become profitable. In August 2006 the Baton Rouge Facility was designated as a Bariatric Center of Excellence by the American Society for Bariatric Surgery (ASBS). The ASBS Center of Excellence designation recognizes surgical programs and surgeons who have demonstrated a track record of favorable short and long-term outcomes in bariatric surgery and have the resources to perform safe bariatric surgeries.

**Industry Background**

The development of proprietary general acute care hospital networks occurred during the 1970 s. During the past 20 years, freestanding outpatient surgery centers were developed to compete with these general hospitals for outpatient procedures. Freestanding outpatient surgery centers have allowed physicians to perform outpatient procedures in specialized facilities designed to improve efficiency and enhance patient care. The Company believes that its operational model allows physicians to perform inpatient procedures at facilities that provide similar efficiencies as those provided at freestanding outpatient surgery centers.

General acute care hospitals specializing in specific complex surgical procedures are designed with the goal of improving both physician and facility efficiency. The surgeries performed are primarily non-emergency procedures that are electively scheduled and, therefore, allow for efficiency available through block time/scheduling. Given the opportunity to utilize multiple operating rooms for pre-determined periods of time, the physicians are able to schedule their time more efficiently and, therefore, increase the number of procedures they can perform within a given amount of time. The facility receives the benefit of consistent staffing patterns and greater facility utilization. In addition, the Company believes that, due to the relatively small size of its facilities, many physicians prefer to perform procedures in the Company s facilities because their patients prefer the comfort of a more personal atmosphere and the convenience of simplified admission and discharge procedures.

**Pasadena Facility**

At August 31, 2006, the Company owned, through its subsidiaries, a 98.5% partnership interest in the Pasadena Facility operating entity, with the remaining interest owned primarily by physicians and other healthcare professionals. The Pasadena Facility s areas of practice include orthopedic and general surgery, such as spine and bariatric surgeries, various pain management modalities and other services. The Pasadena Facility represented approximately 57%, 72% and 87% of the Company s net patient revenues in fiscal years 2006, 2005 and 2004, respectively. Through its affiliates, the Company owns 100% of the real estate and owns or leases 100% of the equipment and, in turn, leases the land, hospital facility and equipment to the hospital operating entity.

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**Garland Facility**

The Garland Facility began performing surgical procedures in November 2003. The areas of practice performed at this facility are orthopedic surgery, bariatric surgery, general surgery and pain management procedures. As of August 31, 2006, the Company owned, through its subsidiaries, a 97% partnership interest in the Garland Facility operating entity, with the remaining interests owned by physicians. Through its affiliates, the Company owns 100% of the real estate and owns or leases 100% of the equipment and, in turn, leases the land, hospital facility and equipment to the hospital operating entity. The Garland Facility represented approximately 43%, 27% and 13% of the Company s net patient revenues in fiscal years 2006, 2005 and 2004, respectively. The Garland Facility s first full year of operations was fiscal year 2005.

**China Project**

On May 16, 2005, the DeAn Joint Venture, of which the Company owns a 70% equity interest, entered into land use agreements with the Chinese government to lease for a term of 50 years approximately 28.88 acres of government-owned land in Shanghai, China. The land is to be used for the China Project.

In accordance with the Land Use Right Agreement, construction of the peripheral walls commenced in October 2005, and the DeAn Joint Venture is currently negotiating a contract for the construction of the hospital. If the hospital is not completed on or before November 16, 2008, the land authority may revoke the land use right without compensation to the DeAn Joint Venture and take over all construction and fixtures on the land. The DeAn Joint Venture may apply to the Jiading Land Bureau for an extension upon the expiration of the land use right, provided that the joint venture has extended its business license over 50 years. If the extension for the land use right is approved by the Land Bureau, the joint venture will need to sign renewed land use right agreements and pay land premiums as required by the Land Bureau. If the joint venture does not apply for an extension of the land use right or the application is rejected, the land use right, as well as the buildings and other site equipment, would be taken back by the government without payment.

The Company is currently required to make contributions to the DeAn Joint Venture of approximately $8.7 million before June 2, 2007 (previously reported as March 31, 2007). Approximately $4.3 million of such amount has been paid by the Company to the DeAn Joint Venture. The Company was required to make a contribution to the DeAn Joint Venture of approximately $2.2 million on June 2, 2006 (previously reported to be due March 31, 2006). That payment was not made, resulting in a technical default under the Joint Venture Agreement. Dynacq has received no notice of default under the Joint Venture Agreement or demand for this payment, and the Chinese government has not yet made payments due by it under the Joint Venture Agreement. The remedies for failure to make a payment under the Joint Venture Agreement are that the venturer will lose its right to vote on joint venture matters and may need to provide additional capital in order for the joint venture to maintain its qualification to do business. The Company is negotiating with the Chinese government for a new timetable for the payment by both joint venturers of the amounts due under the Joint Venture Agreement or for the sale by the government of its interest in the DeAn Joint Venture to a third party.

**Baton Rouge Facility**

At August 31, 2006, the Company owned, through its subsidiaries, a 90% membership interest in the Baton Rouge Facility operating entity, with the remaining interest owned by physicians. The Baton Rouge Facility s areas of practice include bariatric surgery, general surgery and cosmetic surgery. Through its affiliates, the Company owns 100% of the real estate and owns or leases 100% of the equipment and, in turn, leases the land, hospital facility and equipment to the hospital operating entity. The Company has made the decision to sell the assets related to its Baton Rouge Facility, and has included it as part of its discontinued operations. The Company is attempting to locate a buyer for the Baton Rouge Facility.

**West Houston Facility**

The West Houston Facility is a satellite ambulatory surgical center to the Pasadena Facility. The West Houston Facility houses two operating rooms. This facility s areas of practice include pain management, invitro fertilization and other services. The Company has made the decision to sell the assets related to its West Houston Facility, and

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has included it as part of its discontinued operations. The Company is attempting to locate a buyer for the West Houston Facility.

**Business Growth Strategy**

The Company has focused on developing and expanding its surgical services facilities. The Company s current business strategy involves:

- Creating and maintaining relationships with quality physicians;
- Attracting and retaining key management, marketing and operating personnel;
- Further developing and refining its hospital prototype to, among other things, enhance the facility design of its hospitals to provide efficient, effective, and quality patient care for its current surgical mix as well as additional types of services;
- Adding new capabilities to its existing hospital campuses;
- Constructing and developing the China Project; and
- Entering into contracts with workers compensation insurance providers network.

*Creating and Maintaining Relationships with Quality Physicians*

Since physicians provide and influence the direction of healthcare, we have developed our operating model to encourage physicians to affiliate with us and to use our facilities in accordance with their practice needs. Our strategy is to focus on the development of physician partnerships and facilities that will enhance their practices in order to provide quality healthcare in a friendly environment for the patient. We seek to attract new physicians to our facilities in order to grow or to replace physicians who retire or otherwise depart from time to time, as well as to expand the surgical case mix. In order to attract new physicians and maintain existing physician relationships, the Company affords them the opportunity to purchase interests in the operating entities of the facilities. By doing so, the physician becomes more integrally involved in the quality of patient care and the overall efficiency of facility operations.

*Attracting and Retaining Key Personnel*

We place the utmost importance on attracting and retaining key personnel to be able to provide quality facilities to attract and retain qualified physicians. Attracting and retaining the appropriate personnel at all levels within the organization, including senior executives at the corporate level, are also important goals of management and essential in expanding our operations.

*Further Refining Hospital Design*

We believe we attract physicians because we design our facilities and adopt staffing, scheduling and clinical systems and protocols to increase physician productivity and promote their professional success. We focus attention on providing physicians with quality facilities designed to improve the physicians and their patients satisfaction.

*Adding New Capabilities to Existing Hospitals*

Our overall strategy is to develop and operate hospitals designed to handle complex surgeries. Currently, some of our more complex surgeries include spine and bariatric surgeries for which we have added more surgical equipment. The Company continues to explore the possibility of adding other types of surgical procedures that fit into our business model.

*Constructing and developing the China Project*

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The Company plans to build a general acute care hospital with up to 150 beds and eight surgical suites to perform general and specialized surgeries. The Company plans to attract various medical specialty treatment centers as anchors to the hospital, such as cancer, cardiac catheterization, organ transplant and specialty obstetrics and gynecology, complemented by research and development facilities where American specialists can train local physicians with advanced medical techniques and knowledge. Our master plan for development of the China Project includes the construction with other venturers of hotels, convention facilities and living quarters to accommodate the needs of physicians, surgeons, scholars, patients and their families in the medical center campus. The Company is negotiating construction contracts with local contractors pending the final approval of both the architect and construction plans by the local government in China.

*Contracting with workers compensation insurance providers*

Currently, there are 17 certified networks of workers compensation insurance providers and 19 additional networks known to be in the process of certification. The Company is a participant in one network and has applied to become a participant in other certified networks, and will participate in those networks that provide adequate compensation for medical services provided.

**Marketing**

Our marketing efforts are directed primarily at physicians and other healthcare professionals who are principally responsible for referring patients to our facilities. We market our facilities to physicians by emphasizing the high level of patient satisfaction with our hospitals, the quality and responsiveness of our services and the practice efficiencies provided by our facilities. We believe that providing quality facilities creates a positive environment for patients and physicians. The Company, through its subsidiaries, also has agreements with outside organizations that offer marketing, pre-authorization and follow up support services to prospective orthopedic and/or bariatric patients in areas serviced by the Pasadena and/or Garland Facilities. These facilities receive orthopedic and bariatric referrals from other sources, and such organizations also refer clients to other area hospitals.

In addition to our arrangements with outside organizations regarding marketing, we have implemented new bariatric or weight control programs at the Pasadena Facility in the first quarter of fiscal 2006 and at the Garland Facility in the second quarter of fiscal 2006, to replace the former bariatric programs at those facilities and to reduce costs associated with outside vendor programs. Our new programs provide or contract for marketing, pre-authorization and follow up support services to prospective bariatric patients in areas serviced by the Pasadena or Garland Facilities.

**Competition**

Presently, the Company operates in the greater Houston, Texas, Baton Rouge, Louisiana, and Dallas-Fort Worth, Texas metropolitan markets. In each market, the Company competes with other providers, including major acute care hospitals. These entities may have various competitive advantages over the Company, including their community position, capital resources, physician partnerships and proximity to physician office buildings. The Company also encounters competition with other companies for strategic relationships with physicians.

There are several large publicly-held companies, and numerous privately-held companies, that acquire and develop freestanding private hospitals and outpatient surgery centers. Many of these competitors have greater financial and other resources than the Company. The principal competitive factors that affect the Company s ability and the ability of its competitors to acquire or develop private hospitals are experience, reputation, relationships with physicians and other medical providers, as well as access to capital. Further, some surgeon groups develop surgical facilities without a corporate partner. The Company can provide no assurance that it will be able to compete successfully in these markets.

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**Government Regulation**

*Overview*

All participants in the healthcare industry are required to comply with extensive government regulation at the federal, state and local levels. Under these laws and regulations, hospitals must meet requirements for licensure and qualify to participate in government programs, including Medicare and Medicaid. These requirements relate to the adequacy of medical care, equipment, personnel, operating policies and procedures, maintenance of adequate records, hospital use, rate-setting, compliance with building codes and environmental protection laws, as well as patient confidentiality requirements. There are also extensive regulations governing a hospital s participation in government programs and payment for services provided to program beneficiaries. These laws and regulations are extremely complex and, in many instances, the industry does not have the benefit of significant regulatory or judicial interpretation. Some of the laws applicable to us are subject to limited or evolving interpretations; therefore, a review of our operations by a court or law enforcement or regulatory authority may result in a determination that could have a material adverse effect on us. Furthermore, the laws applicable to us may be amended or interpreted in a manner that could have a material adverse effect on us.

We believe that our facilities are in substantial compliance with current applicable federal, state and local regulations and standards. In the event of a determination that we violated applicable laws, rules or regulations or if changes in the regulatory framework occur, we may be subject to criminal penalties and/or civil sanctions and our facilities could lose their licenses and/or their ability to participate in government programs. In addition, government regulations frequently change, and when regulations change we may be required to make changes in our facilities, equipment, personnel and services so that our facilities remain licensed and qualified to participate in these programs. One or more of these outcomes could be material to our operations.

*Texas and Louisiana Workers Compensation Systems*

A significant amount of our net revenue results from Texas workers compensation claims and to a significantly lesser extent from Louisiana workers compensation claims. As such, we are subject to the rules and regulations of the TDWC and the Louisiana Workers Compensation Commission.

The 2005 Texas Legislature substantially revised the workers compensation system by implementing workers compensation healthcare networks. Regulations governing workers compensation healthcare networks have recently been adopted. If one of our hospitals chooses to participate in a network, the amount of revenue that will be generated from workers compensation claims will be governed by a network contract.

For claims arising prior to the implementation of workers compensation networks and out of network claims, the Texas Administrative Code provides the specific methodology and procedure for the payment and denial of medical bills by third-party payers for medical services to injured workers in Texas. Specifically, inpatient and outpatient surgical services are either reimbursed pursuant to the Acute In-Patient Hospital Fee Guideline ( AIHFG ) or at a fair and reasonable rate for services in which the fee guideline is not applicable. Should our facility disagree with the amount of reimbursement provided by a third-party payer, we are required to pursue the MDR process at the TDWC to request proper reimbursement for services pursuant to the Texas Labor Code and the Texas Administrative Code. Prior to September 1, 2005, if the MDR process rendered an unsatisfactory determination regarding the amount of reimbursement for our facility s fees, our facility could appeal the decision to SOAH. After September 1, 2005, our hospitals may seek judicial review of an MDR determination only in the district courts of Travis County, Texas. Although this entire process is lengthy, we request optimal reimbursement for services rendered based upon the utilization of this administrative process. Our Company pursues all avenues of reimbursement allowed under the law as mandated by the legislature and state administrative agencies.

Our Company has a significant number of reimbursement disputes where the MDR decision was unsatisfactory to either the insurance carrier or us, and these decisions have subsequently been appealed to SOAH or district court. These disputes fall loosely into categories of disputes over either inpatient services or outpatient services.

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A decision unfavorable to the Company was issued in May of 2006 by an administrative law judge ( ALJ ) at SOAH in a case pending in the stop-loss consolidated docket. That decision was appealed to state district court in May 2006 and may be possibly appealed to the appellate courts. The remaining inpatient cases at SOAH involving the application of the stop-loss methodology had been abated pending the decision in the consolidated docket. In July of 2006, the en banc panel which presides over the Consolidated Stop-Loss Docket at SOAH and which consists of nine administrative law judges, issued a schedule establishing deadlines for both the carriers and the providers to submit briefs regarding the stop-loss issue and for scheduling oral argument. The carriers and the providers submitted their respective briefs, and on November 3, 2006 the en banc panel heard the arguments of both the carriers and providers, but has not yet issued a decision regarding the stop-loss issue. Inpatient stop-loss cases pending at SOAH and in the Travis County District Courts are currently awaiting a decision by the en banc panel and final interpretation of the stop-loss methodology. The Travis County District Court has suggested that it will wait for a decision at SOAH regarding the stop-loss issue.

The outpatient disputes at SOAH have been consolidated into several dockets according to the reimbursement methodology used by the insurance carriers. These large consolidated dockets were abated for approximately three years pending a state district court legal challenge to the validity of the Texas administrative rules at issue. Now that the district court challenge has concluded, the SOAH consolidations for outpatient cases are beginning to move forward. We anticipate that there may be appeals to state district court and possibly the appellate courts of the decisions in one or more of these consolidated dockets.

The delays caused by the unexpected and extended abatements of the SOAH proceedings for both the inpatient and outpatient cases have added significantly to the age of our accounts receivable for these types of services. Although we have consistently acted to move the cases forward, we cannot predict the time that it will take for the consolidated dockets to reach final resolution. If these disputes are ultimately resolved against our positions, it will have a material adverse effect on our financial statements.

The Louisiana Administrative Code provides the specific methodology and procedure for the payment and denial of medical bills by third-party payers for medical services to injured workers. Specifically, for inpatient surgical services, reimbursement is predicated upon the hospital reimbursement schedule. In addition, there is also a reimbursement guideline for outpatient services.

We cannot predict the course of future legislation or changes in current administration of the Texas Labor Code and/or Texas Administrative Code or the Louisiana Administrative Code. We expect that there may be changes in the future, but we are unable to predict their impact on our operations.

*Licensure, Certification and Accreditation*

Our healthcare facilities are subject to state and local licensing regulations ranging from the adequacy of medical care to compliance with building codes and environmental protection laws. The failure to comply with these regulations could result in the suspension or revocation of a healthcare facility s license. To assure continued compliance with these regulations, our facilities are subject to periodic inspection by governmental and other authorities. Moreover, in order to participate in the Medicare and Medicaid programs, each of our hospitals must comply with the applicable regulations of the United States Department of Health and Human Services ( DHHS ) relating to, among other things, equipment, personnel and standards of medical care, as well as comply with all applicable state and local laws and regulations. If a hospital fails to substantially comply with the numerous conditions of participation in the Medicare and Medicaid programs or performs certain prohibited acts, the hospital s participation in the federal or state healthcare programs may be terminated, civil or criminal penalties may be imposed under certain provisions of the Social Security Act, or both**.**

We believe that our hospitals are in substantial compliance with current applicable federal, state and local regulations and standards. However, the requirements for licensure and certification are subject to change. Consequently, in order for our hospitals to remain licensed and certified, it may be necessary from time to time for us to make material changes in our facilities, equipment, personnel and/or services.

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*Professional Licensure*

Healthcare professionals at our facilities are required to be individually and currently licensed or certified under applicable state law and may be subject to numerous Medicare and Medicaid participation and reimbursement regulations. We take steps to ensure that all independent physicians and our employees and agents have the necessary licenses and certifications with their respective licensing agency. We believe that our employees and agents as well as all independent physicians on staff comply with all applicable state licensure laws.

*Corporate Practice of Medicine and Fee-splitting*

Some states, such as Texas, have laws that prohibit unlicensed persons or business entities, including corporations, from employing physicians. Some states also have adopted laws that prohibit direct or indirect payments or fee-splitting arrangements between physicians and unlicensed persons or business entities. Possible sanctions for violations of these restrictions include loss of license, civil and criminal penalties, and rescission of the business arrangements. These laws vary from state to state, are often vague and in most states have seldom been interpreted by the courts or regulatory agencies. We have structured our arrangements with healthcare providers to avoid the exercise of any responsibility on behalf of the physicians utilizing our hospitals that could be construed as affecting the practice of medicine and to comply with all such applicable state laws. However, we cannot assure you that governmental officials charged with the responsibility for enforcing these laws will not assert that we, or the transactions in which we are involved, are in violation of these laws. These laws also may be interpreted by courts in a manner inconsistent with our interpretations.

*Federal Anti-kickback Statute*

The Medicaid/Medicare Anti-kickback Statute prohibits providers and others from soliciting, receiving, offering or paying, directly or indirectly, any remuneration with the intent of generating referrals or orders for services or items covered by a federal healthcare program. Courts have interpreted this statute broadly. A violation of the Anti-kickback Statute constitutes a felony and may be punished by a criminal fine of up to $25,000 for each violation, imprisonment up to five years, or both, civil money penalties of up to $50,000 per violation and damages of up to three times the amount of the illegal kickback and/or exclusion from participation in federal healthcare programs, including Medicare and Medicaid.

The Office of Inspector General at the DHHS (the OIG ), among other regulatory agencies, is responsible for identifying and eliminating fraud, abuse and waste in federal healthcare programs. The OIG carries out this mission through a nationwide program of audits, investigations and inspections. The OIG has published final safe harbor regulations that outline categories of activities that are deemed protected from prosecution under the Anti-kickback Statute. Currently there are statutory exceptions and safe harbors for various activities, including the following: investment interests, space rental, equipment rental, practitioner recruitment, personal services and management contracts, sale of practice, referral services, warranties, discounts, employees, group purchasing organizations, waiver of beneficiary coinsurance and deductible amounts, managed care arrangements, obstetrical malpractice insurance subsidies, investments in group practices, freestanding surgery centers and referral agreements for specialty services. Compliance with a safe harbor is not mandatory. The fact that a particular conduct or a business arrangement does not fall within a safe harbor does not automatically render the conduct or business arrangement illegal under the Anti-kickback Statute. Such conduct and business arrangements, however, may lead to increased scrutiny by government enforcement authorities. The determination as to compliance with the Anti-kickback statute outside of a safe harbor rests on the particular facts and circumstances and on the parties intent in entering into the transaction or arrangement.

The safe harbor regulations with respect to investment interests establish two instances in which payments to an investor in a venture will not be treated as a violation of the Anti-kickback Statute. The first safe harbor is for investment interests in public companies that have total assets exceeding $50 million and whose investment securities are registered pursuant to the Securities Exchange Act of 1934, as amended (the Exchange Act ). The second safe harbor or small entity safe harbor is for investments in entities when certain criteria are met. Two significant criteria for this safe harbor are (1) that no more than 40% of the value of the investment interests of each class of investments may be held in the previous fiscal year or previous twelve-month period by investors who are in a position to make or influence referrals to, furnish items or services to, or otherwise generate business, for the

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entity, and (2) that no more than 40% of the gross revenue of the entity in the previous fiscal year or previous twelve-month period may come from referrals or business otherwise generated from investors. In addition to promulgating safe harbor regulations, to further assist providers, the OIG has established a process to enable healthcare providers to request advisory opinions on whether individual transactions might violate the Anti-kickback and certain other statutes. The OIG also provides insight into its views on the application of the Anti-kickback Statute through various documents including Special Fraud Alerts, Special Advisory Bulletins, Medicare Fraud Alerts and Medicare Advisory Bulletins.

We have a variety of financial relationships with physicians who refer patients to our hospitals. Physicians own interests in certain of our hospitals and may also own our stock. We also have medical directorship agreements with some physicians. Although we believe that our arrangements with physicians have been structured to comply with the current law and available interpretations, we cannot assure you that regulatory authorities will not determine that these arrangements violate the Anti-kickback Statute or other applicable laws. Also, the states in which we operate have adopted anti-kickback laws, some of which apply more broadly to all payers, not just to federal healthcare programs. Many of these state laws do not have safe harbor regulations comparable to the federal Anti-kickback Statute and have only rarely been interpreted by the courts or other government agencies. If our arrangements were found to violate any of these anti-kickback laws, we could be subject to criminal and civil penalties and/or possible exclusion from participating in Medicare, Medicaid or other governmental healthcare programs such as workers compensation programs. Exclusion from these programs could result in significant reductions in revenue and could have a material adverse effect on our business.

*Stark Law*

The federal physician self-referral statute is commonly known as the Stark law. This law prohibits physicians from referring Medicare and Medicaid patients who need designated health services ( DHS ) to entities with which the physician or an immediate family member has a financial relationship and prohibits the entities from billing Medicare or Medicaid for services ordered pursuant to a prohibited referral. Stark does, however, have a number of exceptions that permit financial relationships between physicians and entities providing DHS. Sanctions for violating the Stark law include denial of payment, refunding amounts received for services provided pursuant to prohibited referrals, civil monetary penalties of up to $15,000 per prohibited service provided and exclusion from the Medicare and Medicaid programs. The statute also provides for a penalty of up to $100,000 for a circumvention scheme that has the principal purpose of assuring referrals and that, if directly made, would violate the Stark law.

One of the exceptions utilized to exempt hospital-provided DHS from the ownership proscription is commonly referred to as the whole hospital exception. This exception permits a physician with an ownership interest in a hospital to make referrals to that hospital provided that: (1) the referring physician is authorized to perform services at the hospital; and (2) the physician s ownership or investment interest is in the entire hospital and not merely in a distinct part or department of the hospital. We believe we have structured our financial arrangements with physicians to comply with the whole hospital exception.

The Stark law may be amended in ways that we cannot predict at this time, including possible changes to the current physician ownership and compensation exceptions. We cannot predict whether any other law or amendment will be enacted or the effect they might have on us.

*State Anti-kickback and Physician Self-Referral Laws*

Many states, including those in which we do or expect to do business, have laws that prohibit payment of kickbacks or other remuneration in return for the referral of patients. Some of these laws apply only to services reimbursable under state Medicaid programs. However, a number of these laws apply to all healthcare services in the state, regardless of the source of payment for the service. Based on court and administrative interpretations of the federal Anti-kickback Statute, we believe that the Anti-kickback Statute prohibits payments only if they are intended to induce referrals. However, the laws in most states regarding kickbacks have been subjected to more limited judicial and regulatory interpretation than federal law. Therefore, we can give you no assurances that our activities will be found to be in compliance with these laws. Noncompliance with these laws could subject us to penalties and sanctions and could have a material adverse effect on us.

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A number of states, including those in which we do or expect to do business, have enacted physician self-referral laws that are similar in purpose to the Stark law but which impose different restrictions. Some states, for example, only prohibit referrals when the physician s financial relationship with a healthcare provider is based upon an investment interest. Other state laws apply only to a limited number of designated health services. Some states do not prohibit referrals, but require that a patient be informed of the financial relationship before the referral is made. We believe that our operations are in material compliance with the physician self-referral laws of the states in which our facilities are located.

*Other Fraud and Abuse Provisions*

The Health Insurance Portability and Accountability Act of 1996 ( HIPAA ) broadened the scope of certain federal fraud and abuse laws by adding several criminal provisions for healthcare fraud offenses that apply to all health benefit programs. HIPAA also added a prohibition against incentives intended to influence decisions by Medicare beneficiaries as to the provider from which they will receive services. In addition, HIPAA created new enforcement mechanisms to combat fraud and abuse, including the Medicare Integrity Program and an incentive program under which individuals can receive up to $1,000 for providing information on Medicare fraud and abuse that lead to the recovery of at least $100 of Medicare funds. HIPAA was followed by The Balanced Budget Act of 1997, which created additional fraud and abuse provisions, including civil penalties for contracting with an individual or entity that the provider knows or should know is excluded from a federal healthcare program.

The Social Security Act also imposes criminal and civil penalties for making false claims and statements to Medicare and Medicaid programs. False claims include, but are not limited to, billing for services not rendered or for misrepresenting actual services rendered in order to obtain higher reimbursement, billing for unnecessary goods and services, and cost report fraud. Criminal and civil penalties may be imposed for a number of other prohibited activities, including failure to return known overpayments, certain gainsharing arrangements, and offering remuneration to influence a Medicare or Medicaid beneficiary s selection of a healthcare provider. Like the Anti-kickback Statute, these provisions are very broad. Careful and accurate coding of claims for reimbursement, as well as accurately preparing cost reports, must be performed to avoid liability.

*The Federal False Claims Act and Similar State Laws*

A factor affecting the healthcare industry today is the use of the Federal False Claims Act and, in particular, actions brought by individuals on the government s behalf under the False Claims Act s qui tam, or whistleblower, provisions. Whistleblower provisions allow private individuals to bring actions on behalf of the government alleging that the defendant has defrauded the federal government.

When a defendant is determined by a court of law to be liable under the False Claims Act, the defendant may be required to pay three times the actual damages sustained by the government, plus mandatory civil penalties of between $5,500 and $11,000 for each false claim submitted. There are many potential bases for liability under the False Claims Act. Liability often arises when an entity knowingly submits a false claim for reimbursement to the federal government. The False Claims Act defines the term knowingly broadly. Thus, although simple negligence will not give rise to liability under the False Claims Act, submitting a claim with reckless disregard to its truth or falsity constitutes a knowing submission under the False Claims Act and, therefore, will qualify for liability.

In some cases, whistleblowers and the federal government have taken the position that providers who allegedly have violated other statutes, such as the Anti-kickback Statute and the Stark law, have thereby submitted false claims under the False Claims Act. Certain states in which we operate have adopted their own false claims provisions as well as their own whistleblower provisions whereby a private party may file a civil lawsuit in state court.

The regulations governing reimbursement under the Medicare and Medicaid programs are very complex. Third-party payers may also have complicated requirements that must be adhered to by healthcare providers. These rules are not always clear and may be subject to interpretation. It is necessary to ensure that claims submitted for reimbursement are accurately coded and completed. Failure to comply with these services and coding requirements can result in denials of payments or the recoupment of payments already received.

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*Health Information Security and Privacy Practices*

The Administrative Simplification provisions of HIPAA require certain organizations, including us, to implement very significant business and operational systems designed to protect each patient s individual healthcare information. Among the standards that the DHHS adopted pursuant to HIPAA are standards for the following:

- electronic transactions and code sets;
- unique identifiers for providers, employers, health plans and individuals;
- security and electronic signatures;
- privacy; and
- enforcement.

Pursuant to HIPAA, we are obligated to appoint and have appointed privacy and security officers, analyzed our existing patient record confidentiality system, developed systems to meet the increased confidentiality requirements in the areas of both privacy and security, drafted and implemented policies and procedures to maintain those systems, trained all relevant personnel in the policies and procedures, monitored the systems on an on-going and continuous basis, notified every new and existing patient of our confidentiality practices and contracted with certain vendors to assure they adhere to the same strict confidentiality and security standards.

In addition, the transaction standards require us to use standard code sets established by the rule when transmitting health information in connection with some transactions, including health claims and health payment and remittance invoices. We believe we are in substantial compliance with the standards that have been implemented to date by DHHS.

The imposition of HIPAA privacy, security and transactional code set standards on healthcare providers, among others, is a substantial step by the federal government toward requiring that individual health and medical records are developed, maintained and billed for in electronic format. The rules continue to be amended and, as such, we will continue to modify our systems in order to maintain compliance with the standards.

A violation of the privacy standards could result in civil money penalties of $100 per incident, up to a maximum of $25,000 per person per year per standard. The final rule also provides for criminal penalties of up to $50,000 and one year in prison for knowingly and improperly obtaining or disclosing protected health information, up to $100,000 and five years in prison for obtaining protected health information under false pretenses, and up to $250,000 and ten years in prison for obtaining or disclosing protected health information with the intent to sell, transfer or use such information for commercial advantage, personal gain or malicious harm. Effective March 16, 2006, the DHHS adopted final rules for the imposition, by the Secretary of Health and Human Services, of civil monetary penalties on entities that violate the administrative simplification provisions of HIPAA. The final rule amends the existing rules relating to the investigation of noncompliance to make them apply to all of the HIPAA Administrative Simplification rules, rather than exclusively to the privacy standards. It also amends the existing rules relating to the process for imposition of civil money penalties. Among other matters, the final rule clarifies and elaborates upon the investigation process, bases for liability, determination of the penalty amount, grounds for waiver, conduct of the hearing and the appeal process. The act also provides for criminal penalties for violations. We have established a plan and committed the resources necessary to comply with HIPAA. At this time, we anticipate that we will be able to maintain compliance with HIPAA regulations that have been issued and with the proposed regulations. Based on the existing and proposed regulations and anticipated additions and amendments to the regulation, we believe that the cost of our compliance with HIPAA will not have a material adverse effect on our results of operations.

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*Emergency Medical Treatment and Labor Act*

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

Although we believe that our emergency care practices are in compliance with EMTALA requirements, we cannot assure that CMS or others will not assert that our facilities are in violation or predict any modifications that CMS will implement in the future. On May 13, 2004, CMS issued revised interpretive guidelines for surveyors investigating EMTALA complaints that require, in addition to other changes, that hospitals have call coverage that meets the needs of hospital patients. Additionally, on August 18, 2006, CMS published changes to Hospital Inpatient Prospective Payment Systems and Fiscal Year 2007 Rates and included changes to the responsibilities of Medicare hospitals in emergency cases under EMTALA. Specifically, the definition of Labor is revised to expand the types of health care practitioners who may certify false labor and the responsibilities of hospitals with specialized capabilities to accept transfers of patients are articulated. We cannot predict whether we will be in compliance with any new requirements or interpretive guidelines.

*Healthcare Reform*

As one of the largest industries in the United States, healthcare continues to attract significant legislative interest and public attention. In recent years, various legislative proposals have been introduced or proposed in Congress and in some state legislatures that would affect major changes in the healthcare system, either nationally or at the state level. Many states have enacted or are considering enacting measures designed to reduce their Medicaid expenditures and change private healthcare insurance. We cannot predict the course of future healthcare legislation or other changes in the administration or interpretation of governmental healthcare programs or the effect that any legislation, interpretation or change may have on us.

*Conversion Legislation*

Many states have enacted or are considering enacting laws affecting the conversion or sale of not-for-profit hospitals. These laws, in general, include provisions relating to attorney general approval, advance notification and community involvement. In addition, state attorneys general in states without specific conversion legislation may exercise authority over these transactions based upon existing law. In many states there has been an increased interest in the oversight of not-for-profit conversions. We may effect a conversion of a not-for-profit hospital in the future and accordingly, the adoption of conversion legislation and the increased review of not-for-profit hospital conversions may increase the cost and difficulty or prevent our completion of transactions with not-for-profit organizations in certain states in the future.

*Certificate of Need*

Some states require state approval for construction and expansion of healthcare facilities, including findings of need for additional or expanded healthcare facilities or services. Certificates of need, which are issued by governmental agencies with jurisdiction over healthcare facilities, are sometimes required for capital expenditures exceeding a prescribed amount, changes in bed capacity or services and certain other matters. Currently, we do not operate in any state that requires a certificate of need. Should we desire to expand our operations to any jurisdiction where a certificate of need will be required, we are unable to predict whether we will be able to obtain any such certificate of need.

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*Environmental Regulation*

Our facilities operations generate medical waste that must be disposed of in compliance with federal, state and local environmental laws, rules and regulations. These operations also are subject to compliance with various other environmental laws, rules and regulations. We cannot predict whether the cost of such compliance will have a material effect on our future capital expenditures, earnings or competitive position.

**Insurance**

The Company maintains various insurance policies that cover each of its facilities. Specifically, the Company has claims-made malpractice coverage for its West Houston Facility and has occurrence coverage for its Pasadena and Garland Facilities. In Louisiana, the Company is a member of the Louisiana Patient Compensation Fund and purchases insurance through the Louisiana Patient Compensation Fund for medical malpractice. In addition, all physicians granted privileges at the Company s facilities are required to maintain medical malpractice insurance coverage. The Company also maintains general liability and property insurance coverage for each facility, including flood coverage. The Company maintains workers compensation coverage for the Baton Rouge Facility, but does not currently maintain worker s 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.

**Employees**

As of October 28, 2006, the Company employed approximately 267 full-time employees and 65 part-time employees, which represents approximately 294 full-time equivalent employees.

**Available Information**

We file proxy statements and annual, quarterly and current reports with the U.S. Securities and Exchange Commission ( SEC ). You may read and copy any document that we file at the SEC s public reference room located at 100 F Street, N.E., Washington, D.C. 20549. You may also call the SEC at 1-800-SEC-0330 for information on the operation of the public reference room. Our SEC filings are also available to you free of charge at the SEC s website at http://www.sec.gov. We also maintain a website at http://www.dynacq.com that includes links to our SEC filings, including our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports. These reports are available on our website without charge as soon as reasonably practicable after such reports are filed with or furnished to the SEC. Information contained on our website is not part of this report.

**Item 1A. Risk Factors**

*The value of an investment in Dynacq Healthcare, Inc. is subject to significant risks, certain of which are specific to our Company, others are inherent in our business and the industry in which we operate, and still others are market related. If any of the matters described in the risk factors listed below were to occur, our business and financial results could be materially adversely affected.*

**Risks Related to our Business**

***We have had a history of losses in recent years.***

We have incurred net losses in each of the last three fiscal years, including losses of approximately $5.9 million in 2006, $5.1 million in 2005, and $1.6 million in 2004. Our ability to operate profitably depends on increasing our patient load, expanding our markets, reducing our operating costs and achieving sufficient gross profit margins. There can be no assurances that we will achieve or maintain profitable operations in the future.

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***Our ability to borrow under our Credit Agreement is limited by our borrowing base.***

Our borrowing capacity under our borrowing base credit facility is based on eligible accounts receivable that we generate from operations. As of August 31, 2006, our borrowing capacity under the facility was $8.2 million, and approximately $6.3 million was outstanding on this facility. All of our collections pay down the balance based on the lockbox account. If our collections on accounts receivable or our eligible receivables decline, our ability to borrow additional amounts under this credit facility will be reduced. In that case, we may be unable to fully fund our budgeted amounts for capital expenditures or meet our obligations to our creditors. Our indebtedness under our credit facility is secured by substantially all of our accounts receivable assets. If we are unable to repay all outstanding balances, the lender could proceed against our assets to satisfy our obligations under the credit facility.

The cash that we generate from our business may not be sufficient to meet our financial obligations, and if we are unable to obtain sufficient additional funds on acceptable terms, our business could be adversely affected. If we are unable to meet our obligations, we will be required to adopt one or more alternatives, such as refinancing, selling material assets or operations or seeking to raise additional debt or equity capital. None of these alternatives may be available to us, and as a result, our operations and financial condition may be significantly adversely impacted.

***Our credit facility contains certain covenants that may limit our flexibility and prevent us from taking certain actions.***

Our credit facility includes a number of significant restrictive covenants which could adversely affect us by limiting our ability to plan for or react to market conditions, meet our capital needs and execute our business strategy. These covenants limit our ability, without the consent of the lender, to, among other things:

- incur certain types and amounts of additional debt;
- consolidate, merge or sell our assets or materially change the nature of our business;
- pay dividends on capital stock and make restricted payments;
- make voluntary prepayments, or materially amend the terms, of subordinated debt;
- enter into certain types of transactions with affiliates;
- make certain investments;
- make certain capital expenditures or incur certain rental obligations; and
- incur certain liens.

Our credit facility also requires us to maintain certain financial ratios and reserves and to satisfy certain financial conditions, several of which may require us to reduce our debt or take some other action in order to comply with the covenants. If we fail to comply with these covenants, we could be in default. In the event of a default, our lender could elect to declare all the amounts borrowed, together with accrued and unpaid interest, to be due and payable. In addition, the lender could elect to terminate its commitment to us, and we or one or more of our subsidiaries could be forced into liquidation or bankruptcy. Any of the foregoing consequences could restrict our ability to execute our business strategy.

***A significant percentage of our revenues are generated through relatively few physicians.***

For the fiscal year ended August 31, 2006, approximately 79% of our gross revenues were generated from 14 surgeons, primarily in our Pasadena Facility. For the fiscal year ended August 31, 2005, approximately 74% of our gross revenues were generated from 12 surgeons, primarily in our Pasadena Facility. For the fiscal year ended August 31, 2004, approximately 57% of our gross revenues were generated from 7 surgeons. The loss of physicians who provide significant net patient revenues for the Company may adversely affect our results of operations.

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***Our inability to fully fund or negotiate an extension for the construction of the China Project may place our investment in that project at risk.***

The Company s failure to make a contribution to the DeAn Joint Venture of approximately $2.2 million on June 2, 2006 resulted in a technical default under the Joint Venture Agreement, although Dynacq has received no notice of default or demand for this payment, and the Chinese government has not yet made payments due by it under the Joint Venture Agreement. The Company is negotiating with the Chinese government for a new timetable for the payment by both joint venturers of the amounts due under the Joint Venture Agreement or for the sale by the government of its interest in the DeAn Joint Venture to a third party. There can be no assurance that we will have sufficient capital to complete the construction and development of the China Project in a timely manner, that we will be able to negotiate a new timetable for payment or the sale of the government s interest to a third party, or that we will be able to recover our investment in the China Project by a sale of our interest in the DeAn Joint Venture.

***Our expansion into international operations could be harmed by economic, political, regulatory and other risks associated with doing business in foreign countries.***

The risks associated with international expansion could adversely affect our ability to expand our business. Expansion of our operations into new markets entails substantial working capital and capital requirements associated with complying with a variety of foreign laws and regulations, complexities related to obtaining agreements from foreign governments and third parties, foreign taxes, and financial risks, such as those related to foreign currency fluctuations. International expansion will also be subject to general geopolitical risks, such as political and economic instability and changes in diplomatic relationships. In many market areas, other healthcare facilities and companies already have significant presence, the effect of which could be to make it more difficult for us to attract patients and recruit qualified physicians. If the hospital is built, there can be no assurances that we will be able to successfully conduct our operations in China. The failure to do so, including the failure to attract patients and to recruit qualified physicians to this facility, could have a material adverse effect on our business, financial condition and results of operations.

***We may not be successful in our newly created bariatric programs.***

We implemented new bariatric or weight control programs at the Pasadena and Baton Rouge Facilities in the first quarter of fiscal 2006 and at the Garland Facility in the second quarter of fiscal 2006. Our new programs replaced outside vendor programs at each of these facilities. These newly implemented programs have placed, and will continue to place, increased demands on our management, operational and financial information systems and other resources. These newly implemented programs have incurred losses during the early stages of operation and, unless and until their caseloads grow, may continue to experience lower total revenues and operating margins. If we are not able to be successful and increase the results of our bariatric programs at each of the facilities, our ability to increase revenues and earnings through these programs would be impaired.

***We are subject to substantial uninsured liabilities for which we have incurred, and may continue to incur, significant expenses.***

In August 2006 we obtained preliminary court approval of the settlement of a class action lawsuit filed by shareholders against us, our directors and officers for allegedly publishing materially misleading financial statements, making materially false or misleading statements or omissions regarding our financial condition, and engaging in a fraudulent schedule to inflate the value of our stock. In fiscal 2005, we also engaged in extensive bankruptcy proceedings on behalf of VHBR, which were concluded in August 2005. These cases, in addition to the legal actions alleging malpractice, product liability or related legal theories that are common in our industry, have involved significant costs and a major drain on management s time and resources. Prospectively, we anticipate our legal expenses to increase because of the new requirements to seek judicial review of MDR determinations in the district courts of Travis County, Texas rather than through an administrative process.

Although we maintain professional malpractice liability insurance and general liability insurance coverage in amounts and with deductibles that we believe to be appropriate for our operations, our insurance coverage may not be sufficient or continue to be available at a cost allowing us to maintain adequate levels of insurance. Our professional malpractice liability insurance has covered the majority of malpractice and related legal claims to date;

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however, the cost of the bankruptcy proceedings and of defending the shareholder derivative suits and any damages awarded as a result of those suits, are paid by the Company. In addition, the large monetary claims and significant defense costs involved in many of the malpractice claims may exceed the limits of our insurance coverage. If one or more successful claims against us were not covered by or exceeded the coverage of our insurance, we could be adversely affected. We do not employ any of the physicians who conduct procedures at our hospitals, and the governing documents of each of our hospitals require physicians who conduct procedures at our hospitals to maintain stated amounts of insurance.

***We indemnify our directors and officers against certain liabilities and do not presently carry director and officer liability insurance.***

As permitted under Delaware law and pursuant to our governing documents and indemnification agreements with certain of our officers and directors, we indemnify our directors against monetary damages for breach of a director s fiduciary duty and advance expenses to the full extent permitted by Delaware law. As a result, shareholders rights to recover against directors for breach of fiduciary duty are limited. We do not carry director and officer liability insurance, so our assets are at risk in the event of successful claims against us or our officers and directors. Our assets may not be sufficient to satisfy judgments against us and our officers and directors in the event of such successful claims. In addition, our lack of director and officer liability insurance may adversely affect our ability to attract and retain highly qualified directors and officers in the future.

***Our inability currently to acquire and develop additional hospitals, or to sell existing facilities held for sale, could limit our future growth.***

One of our strategies to increase our revenues and earnings has historically been to acquire and develop additional hospitals. Currently we are focusing the Company s available resources on constructing and developing the China Project, selling underperforming facilities, and growing internally our existing facilities, and do not plan to pursue an acquisition strategy at the current time. The discontinuance of our acquisition and development strategy will impair our ability to increase revenues and earnings through acquisition growth until the China Project becomes operational. In addition, if we are unable to sell the Baton Rouge Facility, that may impair our ability to fund fully the China Project and to pursue successfully certain of our business strategies.

***We are dependent on certain key personnel.***

The Company is dependent upon a limited number of key management, technical and professional personnel. The Company s future success will depend, in part, upon its ability to attract and retain highly qualified personnel. The Company faces competition for such personnel from other companies and organizations, and there can be no assurance that the Company will be successful in hiring or retaining qualified personnel. The Company does not have written employment agreements with any of its officers providing for specific terms of employment, and officers and other key personnel could leave the Company s employment with little or no prior notice. The Company s loss of key personnel, especially if the loss is without advance notice, or the Company s inability to hire or retain key personnel, could have a material adverse effect on the Company s business, financial condition or results of operations. The Company does not carry any key man life insurance.

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**Risks Associated with our Industry**

***Recent changes in Texas law could adversely affect the Company s operations, collections experience and liquidity.***

In 2005, Texas significantly changed its workers compensation system to require employees whose employers and carriers choose to utilize a network, to seek healthcare from a network healthcare provider. If any one of our hospitals chooses not to participate in a network, or a network refuses one of our hospital s applications to participate in the network, our operations could be adversely affected. In addition, effective September 1, 2005, the amount of reimbursement provided by a third-party payer for claims arising prior to the implementation of workers compensation networks and out of network claims, and not resolved through the MDR process can only be appealed through judicial review of the decision by a Travis County District Court. Any reimbursement pursued through this process may involve delays and compromises due to the subjective nature of the administrative and judicial process and the lack of established timeframes in which the reimbursement disputes are to be resolved. This results in the aging of our receivables which affects our liquidity and, in some instances, actual recoveries. Any modification to current reimbursement guidelines may reduce the amount of our reimbursement for future services, thereby increasing contractual discounts. The fact that our collection process may be longer than other healthcare providers presents inherent risks in ultimate collection.

***If we fail to comply with the extensive laws and complex government regulations applicable to us, we could suffer penalties or be required to make significant changes to our operations.***

The healthcare industry is highly regulated and must comply with extensive government regulation at the federal, state and local levels. Hospitals must meet requirements for licensure, certification to participate in government programs and accreditation. In addition, there are regulatory requirements related to areas such as adequacy and quality of medical care, relationships with physicians and other referral sources (Anti-kickback Statute and Stark law, for example), qualifications of medical and support personnel, billing for services, confidentiality of medical records, emergency care and compliance with building codes. While we believe that we are in substantial compliance with these extensive government laws and regulations, if we fail to comply with any of the laws or regulations we could be subject to criminal penalties and civil sanctions, and our facilities could lose their licenses and their ability to participate in federal and state healthcare programs. In addition, government laws and regulations, or the interpretation of such laws and regulations, may change. In that case, we may have to make changes in our facilities, equipment, personnel, services or business structures so that our facilities may remain licensed and qualified to participate in federal and state programs. If the rules governing reimbursement are revised or interpreted in a different manner or if a determination is made that we did not comply with these requirements, we could be subject to denials of payment or recoupment of payments already received for services provided to patients.

Specifically, the federal Anti-kickback Statute and the Stark law are very broad in scope, and many of their provisions have not been uniformly or definitively interpreted. See Business Government Regulation for an in- depth description of those statutes. If the ownership distributions paid to physicians by our hospitals are found to constitute prohibited payments made to physicians under the Anti-kickback Statute, physician self-referral or other fraud and abuse laws, our business may be adversely affected. Other companies within the healthcare industry continue to be the subject of federal and state investigations that could increase the risk that we may become subject to similar investigations in the future.

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***The failure of any of our workers compensation physicians to participate in a health care network or be on the approved doctor list could negatively impact our operations.***

Since September 2003, the TDWC has required that injured employees in Texas receive healthcare from a doctor on the approved doctors list, except in an emergency or for the immediate post-injury medical care, or after January 1, 2006, from a physician who participates in a workers compensation health care network. Doctors who do not participate in a network must be on the approved list, whether licensed in Texas or licensed by another jurisdiction, and are required to complete training mandated by the TDWC, apply for a certificate of registration and disclose any required financial interests. At this time, we believe that all doctors involved in the care and treatment of patients covered by the Texas Worker s Compensation Act who maintain medical staff privileges at the Company s locations have applied to be on the approved list and have either been granted a temporary exception or have been placed on the approved list. The TDWC reserves the right to review a doctor at any time and take action at a later date for all doctors currently placed on the approved list. The failure of any of our physicians to attain or maintain listing on the approved list or to participate in a network could adversely affect our operations.

***If laws governing the corporate practice of medicine change, we may be required to restructure some of our relationships.***

The laws of various states in which we operate or may operate in the future do not or may not permit business corporations to practice medicine, exercise control over physicians who practice medicine or engage in various business practices, such as fee-splitting with physicians. The interpretation and enforcement of these laws vary significantly from state to state. A government agency charged with enforcement of these laws, or a private party, might assert that our arrangements with physicians and physician group practices do not comply with applicable corporate practice of medicine laws. If our arrangements with these physicians and physician group practices were deemed to violate state corporate practice of medicine, fee-splitting or similar laws, or if new laws were enacted rendering these arrangements illegal, we may be required to restructure our relationships with physicians and physician groups, which may have a material adverse effect on our business.

***Our revenues may continue to decrease due to a reduction in payments from third-party payers, a shift in the surgical mix and/or other circumstances over which we have no control.***

We are dependent upon private and governmental third-party sources of payment for the services provided to patients in our healthcare facilities. The amount of payment our facilities receive for their services may be adversely affected by market and cost factors as well as other factors over which we have no control, including federal and state regulations and the cost containment and utilization decisions of third-party payers. The Company s decision to participate in certain managed care contracts may not result in an increase in patient revenues if we are unable to obtain favorable managed care contracts, we are excluded from participation in a managed care contract, or the reimbursement rate for the procedure performed is too low.

Further, complicated reimbursement rules that are subject to interpretation may subject us to denials of payment for services provided or to recoupments of payments already received. We have no control over the number of patients that are referred to our facilities annually or whether such patients will be admitted as inpatients that typically have a higher reimbursement rate per procedure, or outpatients. Fixed fee schedules, capitation payment arrangements, exclusion from participation in managed care programs or other factors affecting payments for healthcare services over which we do not have control could also cause a reduction in our revenues.

***We are dependent upon the good reputation of our physicians.***

The success of our business is dependent upon quality medical services being rendered by our physicians. Any negative publicity, whether from civil litigation, allegations of criminal misconduct, or forfeiture of medical licenses, with respect to any of our physicians and/or our facilities could adversely affect our results of operations. This could occur through the loss of a physician who provides significant revenue to the Company, or decisions by patients to use different physicians or facilities with respect to their healthcare needs. In addition, we have been the subject of negative publicity in news reports focusing on our Pasadena Facility, which has harmed our business and reputation. As the patient-physician relationship involves inherent trust and confidence, any negative publicity

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adversely affecting the reputation of our physicians or our facilities would likely adversely affect our results of operations.

***Our hospitals face competition for patients from other hospitals and healthcare providers.***

The healthcare business is highly competitive, and competition among hospitals and other healthcare providers for patients has intensified in recent years. Generally, other hospitals in the local communities served by most of our hospitals provide services similar to those offered by our hospitals. In addition, the number of freestanding specialty hospitals and surgery and diagnostic centers in the geographic areas in which we operate has increased significantly. As a result, most of our hospitals operate in an increasingly competitive environment. Some of the hospitals that compete with our hospitals are owned by governmental agencies or not-for-profit corporations supported by endowments and charitable contributions and can finance capital expenditures and operations on a tax-exempt basis. Increasingly, we are facing competition by physician-owned freestanding surgery centers that compete for market share in high margin services and for quality physicians and personnel. If our competitors are better able to attract patients, recruit physicians, expand services or obtain favorable managed care contracts at their healthcare facilities, we may experience a decline in patient volume.

***Our hospitals face competition for staffing, which may increase our labor costs and reduce profitability.***

Our operations are dependent on the effort, abilities and experience of the management and medical support personnel, such as nurses, pharmacists and lab technicians, as well as our physicians. We compete with other healthcare providers in recruiting and retaining qualified management and medical support personnel responsible for the day-to-day operations of each of our hospitals. In some markets, the availability of nurses and other medical support personnel has become a significant operating issue to healthcare providers. This shortage may require us to continue to enhance wages and benefits to recruit and retain nurses and other medical support personnel or to hire more expensive temporary personnel. We also depend on the available labor pool of semi-skilled and unskilled employees in each of the markets in which we operate. If our labor costs increase, we may not be able to raise rates to offset these increased costs. Our failure to recruit and retain qualified management, nurses and other medical support personnel, or to control our labor costs could have a material adverse effect on our results of operations.

**Market Risks Related to Our Stock**

***A single stockholder controls a majority of our outstanding shares.***

Our chairman and chief executive officer beneficially owns an aggregate of approximately 54.7% of our issued and outstanding common stock. As a majority stockholder, he is able to control all matters requiring stockholder approval, including the election and removal of any directors and any merger, consolidation or sale of all or substantially all of our assets. In addition, he is in a position to control the management of our business and the appointment of executive officers as well as all management personnel. This concentration of ownership could have the effect of delaying, deferring or preventing a change of control, or impeding a merger or consolidation, takeover or other business combination or sale of all or substantially all of our assets. In the event that this stockholder elects to sell significant amounts of shares of common stock in the future, such sales could depress the market price of our common stock, further increasing the volatility of our trading market.

***Our common stock has a limited trading market, which could affect your ability to sell shares of our common stock and the price you may receive for our common stock.***

Our common stock is currently quoted on the Nasdaq Capital Markets. There is only limited trading activity in our securities. We have a relatively small public float compared to our market capitalization. Accordingly, we cannot predict the extent to which investors interest in our common stock will provide an active and liquid trading market. Due to our limited public float, we may be vulnerable to investors taking a short position in our common stock, which would likely have a depressing effect on the price of our common stock and add increased volatility to our trading market. Furthermore, we have been, and in the future may be subject to, class action lawsuits that further increase market volatility. The volatility of the market for our common stock could have a materially adverse effect

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on our business, results of operations and financial condition. Accordingly, investors must be able to bear the financial risk of losing their entire investment in our common stock.

***Future issuance of additional shares of our stock could cause dilution of ownership interests and adversely affect our stock price.***

We issued 889,143 shares of the Company s common stock in a private placement in fiscal year 2006 at a price per share equal to 70% of the current market price. We may in the future issue more of our authorized and unissued securities at less than market price, resulting in the dilution of the ownership interests of current shareholders. In addition to 84,259,289 shares of common stock we have that are authorized to issue but are unissued, our board may issue up to 5 million shares of preferred stock which may have greater rights than our common stock, without seeking approval from holders of our common stock. In addition, we are obligated to issue an aggregate of 1,017,846 shares of common stock upon the exercise of options currently outstanding under our 1995 Nonqualified Plan and 2000 Incentive Plan. That number represents approximately 6% of our currently outstanding shares. As of August 31, 2006, all these options have an exercise price which is higher than the market price. An additional 3,408,336 shares are subject to options not yet granted under the plans, and we may grant additional options or warrants in the future to purchase shares of our common stock. The exercise price of each option granted under our option plans is equal to the fair market value of the shares on the date of grant, although that price may be substantially less than the value per share on the date of exercise.

***We have not paid cash dividends on our common stock and do not expect to do so in the foreseeable future.***

It has been our policy to use all available funds from operations to improve and expand our current facilities and to acquire new facilities. For that reason, we have never paid cash dividends on our common stock and have no present intention to pay dividends in the foreseeable future. In addition, our credit facility limits the circumstances under which we can pay dividends. Therefore an investor in our common stock should not expect to obtain any economic benefit from owning our common stock prior to a sale of those shares, if then.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties.**

The Company or its subsidiaries own or lease the following properties:

The Pasadena Facility, the office building adjacent to such facility and the land upon which the facilities are located, are owned by a wholly-owned subsidiary of the Company. The hospital is approximately 45,000 square feet, and the office building is approximately 36,000 square feet.

The Garland Facility, including an approximately 90,000 square foot hospital, an approximately 27,000 square foot medical office building and approximately 22.7 acres of land in Garland, Texas, are owned by a wholly-owned subsidiary of the Company.

A Company subsidiary owns approximately four acres of land in The Woodlands, Texas.

The Company leases 7,250 square feet of office space for its executive offices through September 1, 2011 for $6,525 per month. The lessor of the office space is Capital Bank, of which Mr. Earl Votaw, one of the Company s directors, is a director. Management believes that the lease rate being paid is consistent with comparable commercial rates available in the area.

The DeAn Joint Venture in which the Company owns a 70% equity interest has leased approximately 28.88 acres of government-owned land in Shanghai, China for a 50-year term.

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The Baton Rouge Facility, the office building adjacent to such facility and approximately 20 acres of land upon which the facilities are located, are owned by a wholly-owned subsidiary of the Company. The hospital is approximately 49,500 square feet, and the office building is approximately 6,900 square feet.

The Company leases approximately 7,800 square feet for its West Houston Ambulatory Surgery Center as well as its fertility clinic for approximately $16,350 per month pursuant to leases that expire in May 2008.

The Company is attempting to locate buyers for the Baton Rouge and West Houston facilities, and the land in The Woodlands, Texas.

**Item 3. Legal Proceedings.**

In the second quarter of 2004, eight class action lawsuits were filed in the United States District Court for the Southern District of Texas alleging federal securities law causes of action against the Company and various current and former officers and directors. The plaintiffs were persons who purchased shares of the Company s common stock on the open market generally during the period of January 14, 2003 through December 18, 2003. Under the procedures of the Private Securities Litigation Reform Act, the Court consolidated the actions and appointed lead plaintiffs in the matter. An amended complaint was filed on June 30, 2004, asserting a class period of November 27, 2002, through December 19, 2003 and naming additional defendants, including Ernst & Young, LLP, the Company s prior auditors. The amended complaint sought certification as a class action and alleged that the defendants violated Sections 10(b), 20(a), 20(A), and Rule 10b-5 under the Exchange Act by publishing materially misleading financial statements that did not comply with generally accepted accounting principles, making materially false or misleading statements or omissions regarding revenues and receivables, operations and financial results, and engaging in an intentional fraudulent scheme aimed at inflating the value of Dynacq s stock. After the Company filed its Form 10-K for fiscal 2003 on July 30, 2004, the plaintiffs filed a Second Amended Consolidated Class Action Complaint on September 30, 2004. All defendants filed motions to dismiss the complaint. The plaintiffs voluntarily dismissed two of the former officers from the case. The Court dismissed the claims against one former officer and Ernst & Young, LLP, but denied the motions to dismiss the Company and two current officers who are defendants. The parties reached a settlement agreement in principle in August 2006 for $1.5 million, and on October 10, 2006 the parties signed a Stipulation of Settlement setting forth the terms of their proposed settlement of the action. The settlement provides for Dynacq to pay $100,000 within 30 days of final approval of the settlement by the court and to issue a note for $1.4 million to be paid in 36 equal monthly installments beginning 30 days thereafter. The note shall bear interest at 6% per annum and be secured by a deed of trust on the Garland Facility. As a result of this settlement, the Company recorded a $1.5 million charge to operations during 2006. The settlement contains provisions releasing the Company, its two executive officers named as defendants and its subsidiaries from liability and prohibiting the filing of any future claims by the members of the class relating to this matter. Dynacq and its current and former officers and directors did not admit liability or fault for the matters alleged in the lawsuit. On October 18, 2006, the Court signed an order preliminarily approving the settlement, preliminarily certifying the class, and approving the form and substance of the notice to class members. A settlement hearing will be held on January 10, 2007 to determine (a) whether the settlement is fair, reasonable and adequate and should be approved by the court; (b) whether an Order of Final Judgment and Dismissal should be entered; and (c) whether the Fee and Expense Application of plaintiffs counsel should be approved.

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 facility s fees must be made in the district courts of Travis County, Texas in what can often be a lengthy procedure. Please refer to Business Government Regulation Texas and Louisiana Workers Compensation systems and to Management s Discussion and Analysis of Financial Condition and Results of Operations Revenue Recognition Accounts Receivable 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 is currently a party will have a material adverse effect on the Company s results of operations, cash flows or financial condition.

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

None.

**PART II**

**Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

The Company s common stock was quoted on the National Quotation Service Bureau (the Pink Sheets ) for unsolicited trading from April 16 to November 9, 2004, and thereafter until May 2, 2005 on the OTC Bulletin Board under the symbol DYII.OB as well as on the Pink Sheets. On May 3, 2005, the Company s common stock was listed on the Nasdaq Capital Market System and continues to trade under the symbol DYII .

The following table sets forth the high and low bid prices of the common stock for the period from September 1, 2004 to November 9, 2004 as quoted on the Pink Sheets, for the period from November 10, 2004 to May 2, 2005 as quoted on the OTC, and for the period from May 3, 2005 to August 31, 2006 as quoted on the Nasdaq Capital Market System. These over-the-counter prices reflect inter-dealer prices, without retail mark-ups, mark-down or commissions, and may not necessarily represent actual transactions.

| | Highs | Lows |
|---|---|---|
| **FISCAL YEAR 2006** | | |
| Fourth Quarter | $ 2.07 | $ 1.20 |
| Third Quarter | 3.46 | 1.61 |
| Second Quarter | 3.55 | 2.24 |
| First Quarter | 5.00 | 2.62 |
| **FISCAL YEAR 2005** | | |
| Fourth Quarter | $ 5.60 | $ 4.65 |
| Third Quarter: May 3, 2005 May 31, 2005 | 5.25 | 4.71 |
| March 1, 2005 May 2, 2005 | 5.14 | 4.50 |
| Second Quarter | 5.40 | 4.50 |
| First Quarter: November 10, 2004 November 30, 2004 | 5.40 | 4.40 |
| September 1, 2004 November 9, 2004 | 6.80 | 3.75 |

At November 13, 2006, there were approximately 344 record owners of the Company s common stock. This number does not include stockholders who hold the Company s securities in nominee accounts with broker-dealer firms or depository institutions.

The Company has not declared any cash dividends on its common stock for the two most recent fiscal years. The Company intends to retain all earnings for operations and expansion of its business and does not anticipate paying cash dividends in the foreseeable future. Any future determination as to the payment of cash dividends will depend upon the Company s results of operations, financial condition and capital requirements, as well as such other factors as the Company s Board of Directors may consider.

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**Item 6. Selected Financial Data.**

The following historical selected financial data excludes our Baton Rouge and West Houston Facility operations, which are presented as discontinued operations in our financial statements for all periods. The selected financial data below should be read in conjunction with our consolidated financial statements and the notes thereto included in Item 8, in Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and in Risk Factors in Item 1A.

| | Years ended August 31, | | | | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2003** | **2002** |
| Operating Results Data: | | | | | |
| Net patient service revenue | $ 35,989,314 | $ 41,618,151 | $ 39,233,953 | $ 76,029,511 | $ 62,216,292 |
| Income (loss) from continuing operations | (3,118,638) | (2,936,611) | (4,521,360) | 20,137,793 | 14,685,281 |
| Net income (loss) | (5,935,632) | (5,136,934) | (1,608,260) | 20,887,323 | 14,829,487 |
| **Basic:** | | | | | |
| Income (loss) per share from continuing operations | $ (0.21) | $ (0.20) | $ (0.30) | $ 1.36 | $ 1.00 |
| Weighted average common shares | 15,088,227 | 14,851,568 | 14,849,526 | 14,849,504 | 14,686,236 |
| **Diluted:** | | | | | |
| Income (loss) per share from continuing operations | $ (0.21) | $ (0.20) | $ (0.30) | $ 1.29 | $ 0.95 |
| Weighted average common shares | 15,088,227 | 14,851,568 | 14,849,526 | 15,564,217 | 15,490,068 |

| | **2006** | **2005** | **2004** | **2003** | **2002** |
|---|---|---|---|---|---|
| Balance Sheet Data: | | | | | |
| Cash and cash equivalents | $ 3,382,332 | $ 3,337,835 | $ 5,537,776 | $ 1,883,833 | $ 7,583,756 |
| Total assets | 71,272,972 | 72,458,337 | 83,141,832 | 88,136,654 | 53,926,476 |
| Long-term debt | | | | | |
| Total stockholders equity | 54,218,834 | 58,717,602 | 63,210,657 | 64,787,068 | 46,492,856 |

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**Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.**

Our Management s Discussion and Analysis includes forward-looking statements that are subject to risks and uncertainties. Actual results may differ substantially from the statements we make in this section due to a number of factors that are discussed in Item 1A Risk Factors.

During 2006, we classified as discontinued operations our Baton Rouge and West Houston Facilities and are seeking a buyer for each of these facilities. Our operating results for all periods presented reflect these operations as discontinued.

**Executive Summary**

*Asset Held for Sale and Discontinued Operations*

In 2006, the Company decided to sell the assets related to the Baton Rouge and West Houston Facilities, since those operations were not core to our long-term objectives and are not performing consistently with the expectations we had for them at the time we made the investment. The Company has also made the decision to sell its land in The Woodlands, Texas, since it no longer intends to build on that site. None of those assets is encumbered by secured lien or debt, so all proceeds from the sale of any of those assets, net of selling expenses, would be available to pay down the existing revolving credit facility which is based on eligible accounts receivable, improve liquidity for the Company s day-to-day operations, and invest in the Company s core business activities, including the China Project.

*Private Placement*

In May 2006, the Company offered for sale shares of its common stock to a limited number of accredited investors in a private placement at a purchase price of $1.54 per share, which was 70% of the market price of Company stock on the offering date. A total of 889,143 shares were sold, resulting in sales proceeds of $1,369,280. The shares are restricted securities which may not be offered or sold publicly in the United States except pursuant to the effectiveness of a registration statement or an applicable exemption from the registration requirements of the Securities Act. The sales proceeds were used to meet the cash needs of the Company s day-to-day operations.

*Net Patient Service Revenues*

Net patient service revenues declined $5.6 million, or 14%, compared to the prior year period, to $36.0 million, as net patient service revenue from our Garland Facility increased by $4.2 million or 37%, partially offsetting a 31% decline of $9.3 million in net patient service revenue at the Pasadena Facility.

Approximately 57%, 72% and 87% of the Company s net patient service revenue for fiscal years 2006, 2005 and 2004, respectively, were generated at the Company s Pasadena Facility. The Garland Facility contributed 43%, 27% and 13% in net patient service revenues in fiscal years 2006, 2005 and 2004, respectively.

During fiscal years 2006, 2005 and 2004, approximately 54%, 60% and 57% of the Company s gross revenues came from surgeries covered by workers compensation, and approximately 31%, 27% and 30% came from services covered by commercial and other insurance payers, respectively.

The decline in net patient service revenues is due to several reasons discussed below:

Reimbursement by workers compensation insurance payers below the TDWC fee guideline

Increase in competition for specialized surgeons

Decrease in average net patient service revenue per case

*Reimbursement by workers compensation insurance payers*

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The majority of our gross patient service revenues continues to come from surgeries covered by workers compensation. The reimbursement being made to us by the insurance payers is at a rate which is below the TDWC fee guideline. The lower reimbursement rate reduces our historical cash collection rate, which in turn decreases our net patient service revenues. See Accounts Receivable for a description of the receivables associated with workers compensation.

*Increase in competition for specialized surgeons*

The Houston market has recently experienced an increase in the number of surgical hospitals, which has increased the competition for specialized surgeons. The number of bariatric surgeries performed at our Pasadena Facility decreased 44% and 15% in 2006 and 2005, respectively, compared to the prior fiscal years. This decrease has been partially offset by a 400% increase, or 65 additional bariatric surgeries in 2006 compared to 2005 at our Garland Facility. Similarly, inpatient orthopedic surgeries at our Pasadena Facility dropped 30% and 20% in 2006 and 2005, respectively, compared to prior fiscal years.

In fiscal year 2006, we added a net of 30 physicians to the staff at the Pasadena Facility and 18 at the Garland Facility. Of the net 48 physicians added, 16 specialize in orthopedics and pain management, 2 in general and vascular surgery and 5 in bariatric surgery. The remaining 25 are hospital-based physicians who do not generally make referrals to our hospitals or directly generate patient revenues. These additions to our medical staffs have not yet resulted in a material increase in net patient revenues in 2006 or 2005, and as such, the referral rates have not replaced the referral rates of the physicians who left the staff of our Pasadena Facility in fiscal 2004. The utilization rate of our hospitals varies widely among physicians on our medical staffs and among specializations, so an increase in the number of physicians on our medical staffs does not, in itself, result in an increase in patient referrals or revenues. While we attempt to continue to attract and retain additional physicians, the potential loss of physicians who provide significant net patient revenues for the Company may adversely affect our results of operations.

*Decrease in average net patient service revenue per case*

Even though the number of cases decreased only 1% overall in 2006 compared to 2005, the net patient service revenue fell by 14%. This is primarily due to poor reimbursement by workers compensation insurance payers as mentioned above, and a larger decrease in the number of inpatient cases, which typically generate a higher reimbursement rate compared to an outpatient case. The number of inpatient cases dropped 388, or 41%, from 2005 to 2006.

*Update on MDRs*

Following the recent procedural changes implemented by the TDWC on September 1, 2005 regarding appeals in the MDR process, the Company has sought judicial review of TDWC s decisions regarding reimbursement for inpatient and outpatient surgical services at both the administrative level at SOAH and at the district court level in the Travis County District Courts. However, these procedural changes, coupled with the uncertainty created by the lack of an accepted interpretation of the stop-loss methodology, have prevented many, if not all, of the stop-loss cases at all levels of the MDR process from moving forward.

However, in July of 2006, the en banc panel which presides over the Consolidated Stop-Loss Docket at SOAH and which consists of nine administrative law judges, issued a schedule establishing deadlines for both the carriers and the providers to submit briefs regarding the stop-loss issue and for scheduling oral argument. The carriers and the providers submitted their respective briefs, and on November 3, 2006 the en banc panel heard the arguments of both the carriers and providers, but has not yet issued a decision regarding the stop-loss issue. Inpatient stop-loss cases pending at SOAH and in the Travis County District Courts are currently awaiting a decision by the en banc panel and final interpretation of the stop-loss methodology. The Travis County District Court has suggested that it will wait for a decision at SOAH regarding the stop-loss issue.

The MDR process, as it relates to the Company s outpatient surgical services disputes, has made significant progress in the last 90 days. These cases have been divided into four consolidated dockets, one of which is in the

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beginning stages of an expedited discovery period, culminating in the scheduling of trial as early as mid-January 2007 for cases with dates of service from 2001-2002.

*Operating Losses*

Our net loss of $5.9 million for fiscal year 2006 is primarily due to declining revenues discussed above. The net loss includes approximately $545,000 of non-recurring items comprised of the class action lawsuit settlement expense of $1.5 million, partially offset by a Medicare refund of $604,000 for an overpayment settlement, and an extraordinary gain of $351,000 from the buyback of minority interests held in our facilities.

*Marketing*

Our marketing efforts are directed primarily at physicians and other healthcare professionals who are principally responsible for referring patients to our facilities. We market our facilities to physicians by emphasizing the high level of patient satisfaction with our hospitals, the quality and responsiveness of our services and the practice efficiencies provided by our facilities. We believe that providing quality facilities creates a positive environment for patients and physicians. The Company, through its subsidiaries, also has agreements with outside organizations that offer marketing, pre-authorization and follow up support services to prospective orthopedic and/or bariatric patients in areas serviced by the Pasadena and/or Garland Facilities. These facilities receive orthopedic and bariatric referrals from other sources, and such organizations also refer clients to other area hospitals.

In addition to our arrangements with outside organizations regarding marketing, we have implemented new bariatric or weight control programs at the Pasadena Facility in the first quarter of fiscal 2006 and at the Garland Facility in the second quarter of fiscal 2006, to replace the former bariatric programs at those facilities and to reduce costs associated with outside vendor programs. Our new programs provide or contract for marketing, pre-authorization and follow up support services to prospective bariatric patients in areas serviced by the Pasadena or Garland Facilities. The new bariatric programs have resulted in some bariatric cases, however the number of cases generated will have to improve substantially for such programs to become profitable.

*Internal Controls*

Our outside auditors have advised that there were no identified material weaknesses in our internal controls at August 31, 2006. See Item 9A. Controls and Procedures.

Revenue Recognition

Historically, we have not been a party to managed care contracts. We recognize revenue based upon our estimate of the amount of cash which we will collect for the services delivered. We estimate that we will collect the same percentage of our gross invoices for each facility on a case-by-case basis in each period as we have actually collected during the trailing 12 months. What we term contractual allowance is the amount which must be subtracted from gross billed charges to arrive at the net patient service revenue. For the years ended August 31, 2006, 2005 and 2004, our aggregate contractual allowance, as a percentage of gross billed revenues, was 59%, 58% and 57%, respectively.

*Accounts Receivable*

The focus of our business is relatively complex cases with corresponding large facility reimbursements. Our 2006 gross patient service revenue was generated 54% from service to injured Texas workers (worker s compensation) and 31% from out-of-network commercial insurance. The principal cases involved were orthopedic spine surgeries and bariatric surgeries for the morbidly obese, respectively. Our accounts receivable are larger and older than those of typical healthcare companies because of our pursuit of additional reimbursements through the MDR process. Historically the Company has not participated in managed care contracts and has not received a substantial amount of reimbursement from Medicare or Medicaid. However, during the first quarter of fiscal 2006, the Company began participation in certain managed care contracts and anticipates entering into additional contracts

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in the future. So far these contracts have not resulted in any meaningful patient revenues.

Following our approach to revenue recognition, we initially subtract the contractual allowance from the gross receivables. We then subtract an allowance for uncollectible accounts or bad debt reserve, which we estimate at 1% of total outpatient revenue. The great bulk of our receivables are due from insurance carriers.

The MDR process, which is described in detail below, has been curtailed for three years. However, in the summer of 2006 some progress was made in the MDR process, only to be abated again pending a decision regarding the constitutionality of the MDR appellate process as enforced under the 2005 Workers Compensation Act. Final determination of the MDR process will remain abated until the Travis County District Courts render a decision on the appropriate method for resolving pending claims. Because of this extended uncertainty in the MDR process, we do not arbitrarily write off MDR receivables. We evaluate MDR receivables to estimate the amount that should be collected. If that estimate is less than the gross receivables net of contractual allowance and allowance for uncollectible accounts, we then write it down to the estimated collectible amount. At each balance sheet date we also separately classify as long-term receivables all receivables that we expect to collect more than one year from the balance sheet date.

The MDR system as of September 1, 2005 has changed significantly. The system is important to an understanding of our financial statements. The following information provides a more detailed description of the MDR process, as well as others of our critical accounting policies and estimates.

*Critical Accounting Policies and Estimates*

The Consolidated Financial Statements and Notes to Consolidated Financial Statements contain information that is pertinent to the management s discussion and analysis. 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 reported amounts of assets and liabilities and disclosure of any contingent assets and liabilities. Management believes these accounting policies involve judgment due to the significant assumptions and estimates necessary in determining the related asset and liability amounts. Management believes it has exercised proper judgment in determining these estimates based on the facts and circumstances available to its management at the time the estimates were made. The significant accounting policies are described in the Company s financial statements (see Note 1 in Notes to the Consolidated Financial Statements). Of these policies, management believes the following ones may involve a comparatively higher degree of judgment and complexity. We have discussed the development and selection of the critical accounting policies and related disclosures with the Audit Committee of the Board of Directors.

**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 recognize in connection with the Company s services is subject to significant judgments and estimates, which are discussed below.

*Revenue Recognition Policy*

Historically, the Company has not participated in managed care contracts. However, during the first quarter of fiscal 2006, the Company began participation in certain managed care contracts and anticipates entering into additional contracts in the future. So far these contracts have not resulted in any meaningful patient revenues. The Company records revenue pursuant to the following policy. The Company has established billing rates for its medical services that it bills as gross revenue as services are delivered. Gross billed revenues are then reduced by the Company s estimate of the discount (contractual allowance) to arrive at net patient service revenues. Net patient service revenues are based on historical cash collections as discussed below and may not represent amounts ultimately expected to be collected. At such time as the Company can determine that ultimate collections exceeded

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or have been less than the revenue recorded on a group of accounts, additional revenue or reduction in revenue is recorded.

The table below sets forth the percentage of our gross patient service revenue by financial class for the fiscal years 2006, 2005 and 2004:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Workers Compensation | 54% | 60% | 57% |
| Commercial | 31% | 27% | 30% |
| Medicare | 8% | 5% | 5% |
| Medicaid | 1% | % | % |
| Self-Pay | 4% | 4% | 4% |
| Other | 2% | 4% | 4% |

*Contractual Allowance*

The Company computes its contractual allowance based on the ratio of the Company s historical cash collections during the trailing twelve months to gross billed revenue on a case-by-case basis by operating facility. This ratio of cash collections to billed services is then applied to the gross billed services by operating facility. The following table shows gross revenues and contractual allowances for fiscal years 2006, 2005 and 2004:

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Gross billed charges | $ 87,365,456 | $ 100,048,950 | $ 91,540,059 |
| Contractual allowance | 51,376,142 | 58,430,799 | 52,306,106 |
| Net revenue | $ 35,989,314 | $ 41,618,151 | $ 39,233,953 |
| Contractual allowance percentage | 59% | 58% | 57% |

*Accounts Receivable*

Accounts receivable represent net receivables for services provided by the Company. The estimated accounts receivable not expected to be collected within twelve months of the balance sheet date have been shown as long-term receivables and represent receivables that are in the MDR process and legal third-party financial class. The contractual allowance is provided as revenue is recognized. At each balance sheet date, management reviews the accounts receivables for collectibility. If after the review management believes certain receivables are uncollectible, the receivables are written down to the expected collectible amount. The following table shows accounts receivable, the contractual allowance, the allowance for uncollectible accounts, net receivables and the contractual allowance as a percent of gross receivables at August 31, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Current portion of gross receivables | $ 77,197,985 | $ 66,838,824 |
| Current portion of contractual allowance | (65,240,225) | (56,449,788) |
| Current portion of allowance for uncollectible accounts | (848,950) | (678,518) |
| Net current portion of accounts receivable | $ 11,108,810 | $ 9,710,518 |
| Contractual allowance and allowance for uncollectible accounts as a percentage of current gross receivables | 86% | 85% |
| Long term portion of gross receivables | $ 117,437,724 | $ 97,489,085 |
| Long term portion of contractual allowance | (99,246,937) | (82,335,951) |

| | | |
|---|---|---|
| Long term portion of allowance for uncollectible accounts | (1,291,468) | (989,665) |
| Net long term portion of accounts receivable | $ 16,899,319 | $ 14,163,469 |
| Contractual allowance and allowance for uncollectible accounts as a percentage of long term gross receivables | 86% | 85% |

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The contractual allowance stated as a percentage of gross receivables at the balance sheet dates is larger than the contractual 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 contractual allowance. The contractual allowance amounts netted against gross receivables are not adjusted until such time as the final collections on an individual receivable are recognized.

Collections for services provided are generally settled or written off as uncollectible against the contractual allowance within six months of the date of service except for services provided to injured workers in Texas. Because the Company has in recent years focused on providing services to injured workers in Texas, accounts receivable in the workers compensation MDR process have increased.

The MDR process is an established reimbursement resolution process available to providers of healthcare services under the regulations guiding reimbursement for services provided to injured workers in the state of Texas. Accounts generally do not become subject to the MDR process prior to being outstanding for at least 90 days subsequent to patient discharge. For medical services provided to injured workers in the state of Texas, the MDR process is specifically based upon the administrative and statutory regulations promulgated by the Texas Labor Code, the Texas Administrative Code and the Texas Insurance Code. The Company, in conjunction with most of the Texas hospital medical providers, continues its efforts to resolve the pending claims regarding payment for the treatment of injured workers under the Texas workers compensation laws.

If any reimbursement provided by a workers compensation carrier is improper pursuant to the statutory or regulatory guidelines administered by the TDWC, our facilities request and pursue additional reimbursement. Following is a brief discussion on the time-line of a typical workers compensation claim:

Bills are submitted to a carrier within 21 days of date of service.

A carrier has 45 days to respond to provider with payment or an explanation of benefits ( EOB ) indicating the rationale of denial or defense to payment.

The Company forwards a Request for Reconsideration ( RFR ) to a carrier after the 45th day of the carrier s receipt of the bill or after receipt of the EOB.

The carrier has 21 days to respond to the RFR.

Should the carrier fail to respond or provide the reimbursement requested, the Company files a request with the MDR Division of the TDWC. This usually occurs at or about six to eight months after the date of service due to administrative requirements before filing the initial request to TDWC.

Usually 30 to 60 days after filing the initial request with the MDR Division, TDWC will review the MDR request and determine if additional information is needed. TDWC then will forward an MR-116 form requesting any additional documentation and rationale for additional reimbursement. The Company has 14 days after the date of receipt of the MR-116 to provide additional documentation and a position statement that outlines the rationale for the request for additional reimbursement.

TDWC is not required by the Texas Labor Code or the Texas Administrative Code to provide a Finding and Decision within a specific timeframe. Based upon the historical actions of the TDWC, a Finding and Decision is usually received within 3 to 6 months after the supplemental documentation was forwarded to TDWC. However, because of the abatement to the MDR process, a final timetable will remain unknown until the constitutionality of the MDR appellate process as enforced by the 2005 Workers Compensation Act is determined.

For MDR Findings and Decisions issued prior to September 1, 2005:

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After receipt of the TDWC Finding and Decision, the non-prevailing party has the option of appealing the decision with the SOAH within 20 days of receiving the Finding and Decision from TDWC.

A hearing date with SOAH is assigned generally within 90 days; however, this time period is usually extended 6 to 9 months depending on discovery requests. SOAH will issue a decision 30 to 60 days after the contested case hearing or after final closing briefs have been filed.

The SOAH decision may be appealed to the District Court.

For MDR Findings and Decisions issued after September 1, 2005:

After receipt of the TDWC Finding and Decision, the non-prevailing party has the option of seeking judicial review of the Finding and Decision by a district court in Travis County, Texas. The petition is required to be filed within 30 days of the TDWC s issuance of the MDR Finding and Decision. Similarly, a final timetable will remain unknown until the constitutionality of the MDR appellate process as enforced by the 2005 Workers Compensation Act is determined.

The Company has a significant number of reimbursement disputes where the MDR decision was unsatisfactory to either the insurance carrier or us, and these decisions have subsequently been appealed to the State Office of Administrative Hearings (SOAH) or district court. Many of these cases involve the stop-loss rule governing reimbursement to providers. The Company is pursuing these cases aggressively; however the number of cases that the Company has in the dispute resolution process continues to grow, and payment on many of these cases will not be made until certain standards currently in dispute are established. During the last 30 days, significant activity occurred in the resolution of the legal issues controlling these claims. The Travis County District Court has suggested that it will wait for a decision at SOAH regarding the stop-loss issue. The en banc panel at SOAH recently heard the arguments of both the carriers and providers, but has not yet issued a decision regarding the stop-loss issue. The State Department of Insurance, through the office of the Texas Attorney General, has taken a position at least partially supporting the claims made by the Company and other Texas hospitals.

The delays caused by the unexpected and extended abatements of the SOAH proceedings for both the inpatient and outpatient cases have added significantly to the age of our accounts receivable for these types of services. If these disputes are ultimately resolved against the Company s positions, it may have a material adverse effect on the financial statements.

Due to a number of factors outside the Company s control, including changes in the Company s reimbursement collection experience associated with potential changes in the reimbursement environment in which the Company operates, it is possible that management s estimates of patient service revenues could change, which could have a material impact on the Company s revenue and profitability in the future.

*Sources of Revenue and Reimbursement*

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. We do not normally participate in managed care or other contractual reimbursement agreements, principally because they limit reimbursement for the medical services provided. This business model often results in increased amounts of reimbursement for the same or similar procedure, as compared to other healthcare providers. However, there are no contractual or administrative requirements for prompt payment of claims by third-party payers within a specified time frame. As a result, the Company has tended to receive higher amounts of per-procedure reimbursement than that which may be received by other healthcare providers performing similar services. Conversely, despite the increased reimbursement, we may take additional time to collect the expected reimbursement from third-party payers. During the first quarter of fiscal 2006, the Company began participation in certain managed care contracts and anticipates entering into additional contracts in the future. So far these contracts have not resulted in any meaningful patient revenues. Increased participation in managed care contracts and programs may decrease the per-procedure reimbursement that the Company collects in the future for similar services.

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In addition to the fact that our collection process may be longer than other healthcare providers because of our focus on workers compensation and other commercial payers, the collection process can 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. For such cases in which third-party payers did not provide appropriate reimbursement pursuant to these guidelines, the Company pursues further 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.

Surgeries are typically not scheduled unless they are pre-authorized by the insurance carrier for medical necessity. After the surgery, the Company s automated computer system generates a statement of billed charges to the third-party payer. At that time, the Company also requests payment from patients for any remaining amounts that are the responsibility of the patient.

*Allowance for Uncollectible Accounts*

The Company has estimated uncollectible accounts expense of 1% of gross outpatient revenue. The Company normally makes no charge offs against the allowance for uncollectible accounts, as historically all charge offs have been against the contractual allowance. During the fiscal year ended August 31, 2004, the Company charged $222,518 against the allowance for uncollectible accounts. During the fiscal years ended August 31, 2005 and 2006, the Company made no charge offs against the allowance for uncollectible accounts.

**Income Taxes**

SFAS 109, Accounting for Income Taxes, establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns.

**Results of Operations**

| | Year Ended August 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | |
| Net patient service revenue | $ 35,989,314 | 100% | $ 41,618,151 | 100% | $ 39,233,953 | 100% |
| Costs and expenses: | | | | | | |
| Compensation and benefits | 11,041,113 | 31 | 14,137,460 | 34 | 14,494,869 | 37 |
| Medical services and supplies | 7,219,572 | 20 | 8,331,671 | 20 | 6,586,345 | 17 |
| Other operating expenses | 18,750,581 | 52 | 19,119,816 | 46 | 19,501,832 | 50 |
| Provision for uncollectible accounts | 417,123 | 1 | 371,619 | 1 | 343,429 | 1 |
| Loss on disposal or impairment of assets | 161,937 | | 98,602 | | 1,300,000 | 3 |
| Depreciation and amortization | 2,366,013 | 7 | 2,539,208 | 6 | 2,639,527 | 7 |
| Total costs and expenses | 39,956,339 | 111 | 44,598,376 | 107 | 44,866,002 | 114 |
| Operating loss | (3,967,025) | (11) | (2,980,225) | (7) | (5,632,049) | (14) |
| Other income (expense): | | | | | | |
| Rent and other income | 1,058,673 | 3 | 358,631 | 1 | 250,123 | 1 |
| Interest income | 28,682 | | 33,013 | | 10,827 | |
| Interest expense | (419,953) | (1) | (343,863) | (1) | (275,809) | (1) |
| Total other income (expense), net | 667,402 | 2 | 47,781 | | (14,859) | |
| Minority interest in earnings | 129,518 | | 10,213 | | 222,421 | 1 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Loss before income taxes | (3,429,141) | (10) | (2,942,657) | (7) | (5,869,329) | (15) |
| Benefit for income taxes | 310,503 | 1 | 6,046 | | 1,347,969 | 3 |
| Loss from continuing operations | (3,118,638) | (9) | (2,936,611) | (7) | (4,521,360) | (12) |
| Discontinued operations, net of income taxes | (3,248,193) | (9) | (2,200,323) | (5) | 2,714,414 | 7 |

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| | | | | | | |
|---|---|---|---|---|---|---|
| Extraordinary gain, net of $-0- and $102,354 income tax expense in 2006 and 2004, respectively | 431,199 | 1 | | | 198,686 | 1 |
| Net loss | $ (5,935,632) | (16)% | $ (5,136,934) | (12)% | $ (1,608,260) | (4)% |
| **Operational statistics (Number of procedures):** | | | | | | |
| Inpatient: | | | | | | |
| Bariatrics | 208 | | 245 | | 274 | |
| Orthopedics | 305 | | 617 | | 805 | |
| Other | 47 | | 86 | | 94 | |
| Total inpatient procedures | 560 | | 948 | | 1,173 | |
| Outpatient: | | | | | | |
| Orthopedics | 326 | | 394 | | 510 | |
| Other | 1,702 | | 1,281 | | 1,430 | |
| Total outpatient procedures | 2,028 | | 1,675 | | 1,940 | |
| Total procedures | 2,588 | | 2,623 | | 3,113 | |

**Comparison of the Fiscal Years Ended August 31, 2006 and August 31, 2005**

Net patient service revenue decreased by $5,628,837, or 14%, from $41,618,151 to $35,989,314, and total surgical cases decreased by 1% from 2,623 cases in fiscal year 2005 to 2,588 cases in fiscal year 2006. Following are the percentage changes in net patient service revenues and number of cases at the hospital facilities:

| | Percentage increase/(decrease) from 2005 to 2006 | |
|---|---|---|
| **Facility** | **Net patient revenue** | **Cases** |
| Pasadena | (31)% | 11% |
| Garland | 37 | (19) |
| Overall | (14) | (1) |

The net patient revenue per case decreased $1,960, or 12%, from $15,867 in 2005 to $13,907 in fiscal 2006. Although the number of cases at our facilities decreased 1%, the 12% decline in net patient service revenue per case was the result of the increased number of outpatient cases that typically have a lower average reimbursement per procedure. In addition, decreases in net patient service revenue per case were attributable to a change in the surgical mix of cases, and reimbursement by workers compensation insurance payers below the TDWC fee guideline.

The Company computes its contractual allowance based on the ratio of the Company s historical cash collections during the trailing twelve months to gross billed revenue on a case-by-case basis by operating facility. In compliance with this revenue recognition policy, due to slower collections on the receivables associated with the workers compensation dispute resolution process, the Company s contractual allowance as a percentage of gross patient revenue has increased from 58% in 2005 to 59% in 2006.

Total costs and expenses decreased by $4,642,037, or 10%, from $44,598,376 in fiscal 2005 to $39,956,339 in fiscal 2006. The following discusses the various changes in costs and expenses:

Compensation and benefits decreased by $3,096,347, or 22%. During fiscal year 2005, the Company incurred a $431,821 non-cash pre-tax compensation expense related to former employees incentive stock options previously granted. In fiscal year 2005, the Company also incurred a $138,015 non-cash pre-tax compensation expense related to acceleration of vesting of all outstanding stock options and extending the exercise date of a stock option. Excluding these non-cash compensation expenses, the decline in compensation and benefits in the current fiscal year is 19% compared to the prior fiscal year. The Company made a concerted effort to reduce employee costs and expenses to match the decline in revenue.

Medical services and supplies expenses decreased $1,112,099, or 13%, while the number of surgery cases

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decreased 1%. The decrease in medical services and supplies expense was due to an overall increase in outpatient cases, which typically require less medical supplies, from 64% to 78% of total number of cases from 2005 to 2006.

Other operating expenses decreased by $369,235, or 2%. In August 2006, the Company settled in principle the class action lawsuit alleging federal securities law causes of action against the Company for $1.5 million. Setting aside this $1.5 million settlement, the other operating expenses decreased by 10%. The Company made efforts to reduce other operating expenses to match the decline in revenue. The Company also spent approximately an additional $599,000, or 12%, in advertising and marketing costs from $5,012,000 in fiscal year 2005 to $5,611,000 in fiscal year 2006.

Other income increased by $619,621 from $47,781 in 2005 to $667,402 in 2006. The increase in other income is primarily due to a Medicare refund of approximately $604,000 for an overpayment settlement.

The income tax benefit of the net operating loss does not have the expected relationship to net loss due to the Company s utilization of operating loss carry backs in prior years and the uncertainty of realization of operating loss carry forwards in future years.

The loss on discontinued operations represents the losses at our Baton Rouge and West Houston Facilities. The combined net patient service revenues at these facilities decreased $4,313,725, or 32%, from $13,656,710 in 2005 to $9,342,985 in 2006, whereas the total surgical cases increased 18% from 1,196 cases in fiscal year 2005 to 1,406 cases in fiscal year 2006. The net patient revenue per case decreased $4,773, or 42%, from $11,418 in 2005 to $6,645 in fiscal 2006. Although the number of cases at our facilities increased 18%, the 32% decline in net patient service revenue per case was primarily due to a change in the surgical mix of cases. Total costs and expenses of the discontinued operations decreased by $4,123,680, or 24%, from $17,115,888 in fiscal 2005 to $12,992,208 in fiscal 2006. In 2005, the bankruptcy filing of the Baton Rouge Facility caused increased legal fees and other operating expenses of approximately $1,453,000, including a $400,000 expense related to the Liljeberg lawsuit settlement. Setting aside these one-time expenses, the decrease in operating expenses was 17%. The Company made efforts to reduce costs and expenses to match the decline in revenue. Costs and expenses did not reduce proportionately to the decrease in revenues due to fixed overhead and operating expenses, as well as time required to implement cost cutting measures.

The extraordinary gain in fiscal year 2006 of $431,199, net of income taxes, relates to gains on the purchase of minority interests from certain minority interest holders at an amount less than the net book value of the minority interest liability on the date of purchase.

**Comparison of the Fiscal Years Ended August 31, 2005 and August 31, 2004**

Net patient service revenue increased by $2,384,198, or 6%, from $39,233,953 to $41,618,151, and total surgical cases decreased by 16% from 3,113 cases in fiscal year 2004 to 2,623 cases in fiscal year 2005. Following are the percentage changes in net patient service revenues and number of cases at the hospital facilities:

| | Percentage increase/(decrease) from 2004 to 2005 | |
|---|---|---|
| **Facility** | **Net patient revenue** | **Cases** |
| Pasadena | (19)% | (23)% |
| Garland | 120 | (3) |
| Overall | 6 | (16) |

The net patient revenue per case increased $3,263 or 26% from $12,604 in 2004 to $15,867 in fiscal 2005. The increase in net patient revenue per case was primarily due to a change in the mix of orthopedic cases at our Garland and Pasadena Facilities, which performed more complicated cases with higher average revenue. This increase in revenue per case was partially offset by a 11% decline in bariatric cases, such cases having a significantly higher

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average revenue rate. The fiscal year 2005 also includes $681,551 in net revenues generated from physician practice management services. The decline in the number of cases at the Pasadena Facility was primarily the result of the loss of doctors practicing at the facility in fiscal year 2004.

Total costs and expenses decreased by $267,626 or 1% from $44,866,002 in fiscal 2004 to $44,598,376 in fiscal 2005. The following discusses the various changes in costs and expenses:

Compensation and benefits decreased by $357,409 or 2%. During the fiscal year 2005 and 2004, the Company incurred a $431,821 and $1,085,000, respectively, non-cash pre-tax compensation expense related to former employees incentive stock options previously granted. In fiscal year 2005, the Company also incurred a $138,015 non-cash pre-tax compensation expense related to acceleration of vesting of all outstanding stock options and extending the exercise date of a stock option. Excluding these non-cash compensation expenses, the compensation and benefits expense in the fiscal year 2005 increased by 1% compared to the fiscal year 2004. Due to the increase in revenues at the Garland Facility, the compensation and benefits expense increased at that facility by 12%.

Medical services and supplies expenses increased $1,745,326 or 26% while the number of surgery cases decreased 16%. The marginal increase in expenses is due to higher prices paid for medical supplies partially offset by a decrease in the number of cases.

Other operating expenses decreased by $382,016 or 2%. The Company made efforts to reduce other operating expenses to match the decline in revenue. The Company also spent approximately an additional $566,000 or 13% in advertising and marketing costs from $4,446,000 in fiscal year 2004 to $5,012,000 in fiscal year 2005.

During fiscal year 2005, as a result of our recent financial trends and the current outlook for our future operating performance, the Company recorded impairment of goodwill of $98,602. During fiscal year 2004, the Company had recognized an impairment loss of $1.3 million associated with the Company s land at The Woodlands, Texas.

The income tax benefit of the net operating loss does not have the expected relationship to net loss due to the Company s utilization of operating loss carry backs in prior years and the uncertainty of realization of operating loss carry forwards in future years.

The discontinued operations represent our Baton Rouge and West Houston Facilities. The discontinued operations had an income, net of income taxes, of $2,714,414 in fiscal year 2004, and a loss, net of income taxes, of $2,200,323 in fiscal year 2005. The net patient service revenues at these facilities combined decreased $9,958,715, or 42%, from $23,615,425 in 2004 to $13,656,710 in 2005, and the total surgical cases decreased 33% from 1,778 cases in fiscal year 2004 to 1,196 cases in fiscal year 2005. The net patient revenue per case decreased $1,863, or 14%, from $13,282 in 2004 to $11,418 in fiscal 2005. Although the number of cases at our facilities decreased 33%, the 42% decline in net patient service revenue per case was primarily due to a change in the surgical mix of cases, including a 35% drop in number of inpatient cases. Total costs and expenses of the discontinued operations decreased by $2,520,009, or 13%, from $19,635,897 in fiscal 2004 to $17,115,888 in fiscal 2005. In 2004, the bankruptcy filing of the Baton Rouge Facility incurred an $800,000 expense related to the Liljeberg lawsuit settlement. Setting aside this one-time expense, the decrease in operating expenses was 9%. The Company made efforts to reduce costs and expenses to match the decline in revenue. Costs and expenses did not reduce proportionately to the decrease in revenues due to fixed overhead and operating expenses, as well as time required to implement cost cutting measures.

The extraordinary gain in fiscal year 2004 of $198,686, net of income taxes relates to gains on the purchase of minority interests from certain minority interest holders at an amount less than the net book value of the minority interest liability on the date of purchase.

**Liquidity and Capital Resources**

The Company maintained sufficient liquidity to meet its business needs in fiscal 2006. As of August 31, 2006,

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its principal source of liquidity included $3,382,332 in cash.

*Cash flows from operating activities*

Total cash flow used in operating activities was $2,776,381 (including $2,021,179 used in discontinued activities) during fiscal year 2006, primarily due to a net loss of $5,935,632, an increase in accounts receivable of $3,947,337 due to slower collection on MDR accounts, and a $808,708 increase in restricted cash, partially offset by depreciation and amortization of $2,366,013 and general increases resulting from changes in accounts payable and accrued liabilities and collections of income tax receivables. Due to continued negative cash flows from operating activities, in order to meet the cash needs of the Company s day-to-day activities, the Company had a private placement of restricted stock, and raised $1,369,280 during fiscal year 2006. See Note 8 of Notes to Consolidated Financial Statement for further details and also discussion below under Cash flows from financing activities .

In 2006, the Company decided to sell the assets related to the Baton Rouge and West Houston Facilities, since those operations were not core to our long-term objectives, and are not performing consistently with the expectations we had for them at the time we made the investment. The Company has also made the decision to sell its land in The Woodlands, Texas, since it no longer intends to build on that site. None of those assets is encumbered by secured lien or debt, so all proceeds from the sale of any of those assets, net of selling expenses, would be available to pay down the existing revolving credit facility which is based on eligible accounts receivable, improve liquidity for the Company s day-to-day operations, and invest in the Company s core business activities, including the China Project. See also discussion below under Cash flows from investing activities .

*Cash flows from investing activities*

Total cash flow used in investing activities was $231,190 (including $137,359 provided by discontinued activities) during fiscal year 2006, primarily due to purchase of medical equipment. In 2006, the Company decided to sell the assets related to the Baton Rouge and West Houston Facilities, since those operations were not core to our long-term objectives, and are not performing consistently with the expectations we had for them at the time we made the investment. The Company has also made the decision to sell its land in The Woodlands, Texas, since it no longer intends to build on that site. None of those assets is encumbered by secured lien or debt, so all proceeds from the sale of any of those assets, net of selling expenses, would be available to pay down the existing revolving credit facility which is based on eligible accounts receivable, improve liquidity for the Company s day-to-day operations, and invest in the Company s core business activities, including the China Project.

*Cash flows from financing activities*

Total cash flow provided by financing activities was $3,032,771 (including $148,080 used in discontinued activities) during fiscal year 2006. During fiscal year 2006, the Company borrowed $2,491,969 under its Credit Agreement, and paid down $550,000 on the note payable to the former owners of the Garland Facility. Due to continued negative cash flows from operating activities, in order to meet the cash needs of the Company s day-to-day activities, the Company had a private placement of restricted stock, and raised $1,369,280 during fiscal year 2006. See related disclosure under Note 8 of Notes to Consolidated Financial Statement for further details, and also discussion above under Cash flows from operating activities .

The Company had working capital of $2,905,238 as of August 31, 2006, and maintained a liquid position by a current ratio of approximately 1.18 to 1.

The Company and certain of its subsidiaries on May 27, 2005 entered into a Credit and Security Agreement (the Credit Agreement ) with Merrill Lynch Capital for a new five-year revolving credit facility for up to $10 million, subject to a borrowing base based on eligible accounts receivable and further subject to a $2 million reserve until satisfaction of certain conditions. As of August 31, 2006, the Company had drawn $6.3 million of approximately $8.2 million available to it under the Credit Agreement based on its borrowing base at that date. The Company s obligations are secured by a first priority security interest in all existing and future accounts receivable and accounts receivable-related items, other assets and deposit accounts of certain subsidiaries, a pledge of 75% of equity interest in the operating entities of the Garland and Pasadena Facilities and a negative pledge for the equity

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interests in the Company and other subsidiaries. The real estate holding subsidiaries of Dynacq are not borrowers under the Credit Agreement, and their real estate and equipment assets are not pledged to secure the obligations under such facility.

The Credit Agreement, among other things, requires that the Company maintain certain performance financial covenants, restricts its ability to incur certain additional indebtedness, and contains various customary provisions, including affirmative and negative covenants, representations and warranties and events of default. Please refer to the Form 8-K filed on June 1, 2005 for further reference and information.

As of November 7, 2006, the Company had an approximately $4.4 million cash balance. As of November 7, 2006, the Company had paid down approximately $74,000 and had drawn the full amount available under the Credit Agreement based on its borrowing base on that date. The availability of borrowings under our Credit Agreement is subject to various conditions as described above.

We believe we will be able to meet our ongoing liquidity and cash needs for fiscal year 2007 through the combination of available cash, cash flow from operations, proceeds from sales of assets, and borrowings under our Credit Agreement. Our inability to generate sufficient cash flow from operations and borrowings under our Credit Agreement to meet our cash needs may cause us to sell certain of our assets held for sale at a time, for a price or under conditions which would not have the optimum results for the Company. However, since none of those assets held for sale is encumbered by secured lien or debt, all proceeds from the sale of any of those assets, net of selling expenses, would be available to meet our ongoing liquidity and cash needs.

**Off-Balance Sheet Arrangements**

We are not a party to any off-balance sheet arrangements that have, or are reasonably likely to have, a material effect on us.

**Contractual Obligations and Commitments**

The following table summarizes our known contractual obligations at August 31, 2006, and the effect such obligations are expected to have on our liquidity and cash flow in the future periods indicated below:

| | | Payments due by period | | | |
|---|---|---|---|---|---|
| | | Less than | | | More than |
| | Total | 1 year | 1 to 3 years | 3 to 5 years | 5 years |
| Marketing Obligations | $ 24,382,500 | $ 7,807,500 | $ 15,600,000 | $ 975,000 | $ |
| Operating Lease Obligations | 1,053,416 | 432,226 | 407,764 | 193,851 | 19,575 |
| Other Contractual Obligations | 11,900,138 | 11,818,475 | 80,057 | 1,606 | |
| Total | $ 37,336,054 | $ 20,058,201 | $ 16,087,821 | $ 1,170,457 | $ 19,575 |

The Company has operating leases primarily for medical and office equipment. The Company also incurs rental expense for office space and medical equipment. Operating lease and rental expense were approximately $1,061,000, $1,218,000 and $1,005,000 in fiscal years 2006, 2005 and 2004, respectively. Future minimum rental commitments under noncancellable leases for the following fiscal years are: 2007, $432,226; 2008, $258,483; 2009, $149,281; 2010, $115,551; 2011, $78,300 and thereafter, $19,575.

In the first quarter of fiscal 2006, the Company, through its subsidiary, also had agreements with outside organizations that offer marketing, pre-authorization and follow up support services to prospective bariatric and orthopedic patients in areas serviced by the Pasadena and Garland Facilities. These facilities received bariatric and orthopedic referrals from other sources, and the organizations referred clients to other area hospitals. Payments made related to these agreements for the fiscal years 2006, 2005 and 2004 were $5,187,000, $4,993,000 and $4,150,000, respectively.

The Company has contracts with doctors to manage various areas of the Company s hospitals and other service agreements. Payments made under these agreements for the fiscal years ending August 31, 2006, 2005 and 2004

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were $3,686,000, $4,820,000 and $3,010,000, respectively. Future minimum payments under the terms of these contracts and agreements for the following fiscal years are: 2007, $1,087,316; 2008, $70,421; 2009, $9,636; and for 2010, $1,606.

*Discontinued operations commitments*

For the Company s discontinued operations, the future minimum rental commitments under noncancellable leases for the following fiscal years are: 2007, $823,598; and for 2008, $679,445. Future minimum payments under the terms of contracts and agreements with doctors and other service agreements for the following fiscal years are: 2007, $1,012,413; 2008, $512,359; and for 2009, $226,218. There is also an obligation of $134,104 payable in 2007 under a capital lease for medical equipment.

**Recent Accounting Pronouncements**

See Note 1 to the consolidated financial statements under *Recent Accounting Pronouncements*, which is incorporated here by reference.

**Inflation**

Inflation has not significantly impacted the Company s financial position or operations.

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

Market risks relating to the Company s operations result primarily from changes in interest rates as well as credit risk concentrations. Except for the capital contributions of approximately $4.3 million to date and the required future contributions of $4.4 million to the DeAn Joint Venture, the majority of which are in local currency, all of the Company s contracts are denominated in US dollars and, therefore, the Company has no significant foreign currency risk.

**Interest Rate Risk**

The Company is exposed to market risk from changes in interest rates on funded debt. The Company had drawn approximately $6.3 million as of August 31, 2006 from its five-year revolving credit facility. The balance owed under the facility as of November 7, 2006 was approximately $6.3 million. Borrowings under the facility bear interest at variable rates based on the LIBOR rate plus 2.85%. Based on the amount outstanding, a 100 basis point change in the applicable interest rates would not have a material impact on the Company s annual cash flow or income.

The Company s cash and cash equivalents are invested in money market accounts. Accordingly, the Company is subject to changes in market interest rates. However, the Company does not believe a change in these rates would have a material adverse effect on the Company s operating results, financial condition and cash flows. There is an inherent rollover risk on these funds as they accrue interest at current market rates. The extent of this risk is not quantifiable or predictable due to the variability of future interest rates.

**Credit Risks**

The Company s financial instruments that are exposed to concentrations of credit risk consist primarily of trade receivables from various private insurers. The Company monitors its exposure for credit losses and maintains allowances for anticipated losses, but does not require collateral from these parties.

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**Item 8. Financial Statements and Supplementary Data**

**INDEX TO FINANCIAL STATEMENTS**

Below is an index to the consolidated financial statements and notes thereto contained in Item 8, Financial Statements and Supplementary Data.

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**Report of Independent Registered Public Accounting Firm**

To the Stockholders and Board of Directors

Dynacq Healthcare, Inc.

Houston, Texas

We have audited the accompanying consolidated balance sheets of Dynacq Healthcare, Inc. (the Company ), as of August 31, 2006 and 2005, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended August 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These consolidated financial statements and schedules are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

We conducted our audits in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Dynacq Healthcare, Inc. at August 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended August 31, 2006, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Killman, Murrell & Company, P. C.
Killman, Murrell & Company, P. C.

Houston, Texas

November 7, 2006

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**Dynacq Healthcare, Inc.**

**Consolidated Balance Sheets**

| | August 31, 2006 | August 31, 2005 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 3,382,332 | $ 3,337,835 |
| Restricted cash | 808,708 | |
| Current portion of accounts receivable, net of contractual allowances of approximately $65,240,000 and $56,450,000 and allowances for uncollectible accounts of approximately $849,000 and $679,000 at August 31, 2006 and 2005, respectively | 11,108,810 | 9,710,518 |
| Accounts receivable other | 14,423 | 673,463 |
| Inventories | 1,751,760 | 2,049,091 |
| Prepaid expenses | 505,454 | 789,360 |
| Deferred tax assets | | 223,201 |
| Income taxes receivable | 1,731,192 | 2,656,984 |
| Total current assets | 19,302,679 | 19,440,452 |
| Assets held for sale | 13,252,800 | 14,899,216 |
| Property and equipment, net | 21,558,200 | 23,664,410 |
| Long term portion of accounts receivable, net of contractual allowances of approximately $99,247,000 and $82,336,000 and allowances for uncollectible accounts of approximately $1,291,000 and $990,000 at August 31, 2006 and 2005, respectively | 16,899,319 | 14,163,469 |
| Other assets | 259,974 | 290,790 |
| Total assets | $ 71,272,972 | $ 72,458,337 |

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

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**Dynacq Healthcare, Inc.**

**Consolidated Balance Sheets (continued)**

| | August 31, 2006 | August 31, 2005 |
|---|---|---|
| **Liabilities and stockholders equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 5,242,314 | $ 3,832,956 |
| Accrued liabilities | 4,613,586 | 3,490,699 |
| Notes payable | 6,339,212 | 4,517,243 |
| Liabilities related to discontinued operations | 130,299 | 278,379 |
| Current taxes payable | 72,030 | 111,387 |
| Total current liabilities | 16,397,441 | 12,230,664 |
| Non-current liabilities: | | |
| Deferred tax liabilities | | 852,494 |
| Total liabilities | 16,397,441 | 13,083,158 |
| Minority interests | 656,697 | 657,577 |
| Commitments and contingencies | | |
| 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, 15,740,711 and 14,851,568 shares issued at August 31, 2006 and 2005, respectively | 15,741 | 14,852 |
| Additional paid-in capital | 13,056,974 | 11,688,583 |
| Accumulated other comprehensive income | 105,659 | 38,075 |
| Retained earnings | 41,040,460 | 46,976,092 |
| Total stockholders equity | 54,218,834 | 58,717,602 |
| Total liabilities and stockholders equity | $ 71,272,972 | $ 72,458,337 |

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

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**Dynacq Healthcare, Inc.**

**Consolidated Statements of Operations**

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Net patient service revenue | $ 35,989,314 | $ 41,618,151 | $ 39,233,953 |
| Costs and expenses: | | | |
| Compensation and benefits | 11,041,113 | 14,137,460 | 14,494,869 |
| Medical services and supplies | 7,219,572 | 8,331,671 | 6,586,345 |
| Other operating expenses | 18,750,581 | 19,119,816 | 19,501,832 |
| Provision for uncollectible accounts | 417,123 | 371,619 | 343,429 |
| Loss on disposal or impairment of assets | 161,937 | 98,602 | 1,300,000 |
| Depreciation and amortization | 2,366,013 | 2,539,208 | 2,639,527 |
| Total costs and expenses | 39,956,339 | 44,598,376 | 44,866,002 |
| Operating loss | (3,967,025) | (2,980,225) | (5,632,049) |
| Other income (expense): | | | |
| Rent and other income | 1,058,673 | 358,631 | 250,123 |
| Interest income | 28,682 | 33,013 | 10,827 |
| Interest expense | (419,953) | (343,863) | (275,809) |
| Total other income (expense), net | 667,402 | 47,781 | (14,859) |
| Loss before income taxes, minority interests and extraordinary gain | (3,299,623) | (2,932,444) | (5,646,908) |
| Minority interest in earnings | 129,518 | 10,213 | 222,421 |
| Loss before income taxes | (3,429,141) | (2,942,657) | (5,869,329) |
| Benefit for income taxes | 310,503 | 6,046 | 1,347,969 |
| Loss from continuing operations | (3,118,638) | (2,936,611) | (4,521,360) |
| Income (loss) from discontinued operations, net of income taxes | (3,248,193) | (2,200,323) | 2,714,414 |
| Extraordinary gain, net of $-0- and $102,354 income tax expense in 2006 and 2004, respectively | 431,199 | | 198,686 |
| Net loss | $ (5,935,632) | $ (5,136,934) | $ (1,608,260) |
| Basic and diluted loss per common share: | | | |
| Loss from continuing operations | $ (0.21) | $ (0.20) | $ (0.30) |
| Income (loss) from discontinued operations, net of income taxes | (0.21) | (0.15) | $ 0.18 |
| Extraordinary gain, net of income taxes | 0.03 | | 0.01 |
| Net loss | $ (0.39) | $ (0.35) | $ (0.11) |
| Basic and diluted average common shares outstanding | 15,088,227 | 14,851,568 | 14,849,526 |

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

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**Dynacq Healthcare, Inc.**

**Consolidated Statements of Stockholders Equity**

| | Common Stock | | Treasury Stock | | | Other Compre-hensive Income Foreign currency transla-tion | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Additional Paid-In Capital | | Retained Earnings | Deferred Compensa-tion | Total |
| Balance, August 31, 2003 | 16,294,343 | $ 16,294 | 1,445,099 | $ (5,813,284) | $ 17,521,843 | $ | $ 53,721,286 | $ (659,071) | $ 64,787,068 |
| Stock issued on exercise of stock options | 105,500 | 106 | | | 500,701 | | | | 500,807 |
| Income tax benefit from exercise of employee stock options | | | | | 46,760 | | | | 46,760 |
| Treasury shares acquired | | | 103,176 | (1,611,165) | | | | | (1,611,165) |
| Amortization of deferred compensation | | | | | | | | 181,800 | 181,800 |
| Charge for amending stock option issued to an employee | | | | | 1,085,000 | | | | 1,085,000 |
| Credit to expense for non-vested options issued to non-employee | | | | | (171,353) | | | | (171,353) |
| Net loss | | | | | | | (1,608,260) | | (1,608,260) |
| Balance, August 31, 2004 | 16,399,843 | 16,400 | 1,548,275 | (7,424,449) | 18,982,951 | | 52,113,026 | (477,271) | 63,210,657 |
| Treasury shares cancelled | (1,548,275) | (1,548) | (1,548,275) | 7,424,449 | (7,422,901) | | | | |
| Amortization of deferred compensation | | | | | | | | 477,271 | 477,271 |
| Charge for accelerating vesting of stock options and extension of exercise date | | | | | 138,015 | | | | 138,015 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Credit to expense for non-vested options issued to non-employee | | | | (9,482) | | | | (9,482) |
| Foreign currency translation adjustment, net of taxes of $19,615 | | | | | 38,075 | | | 38,075 |
| Net loss | | | | | | (5,136,934) | | (5,136,934) |
| Balance, August 31, 2005 | 14,851,568 | 14,852 | | 11,688,583 | 38,075 | 46,976,092 | | 58,717,602 |
| Restricted stock issued in private placement | 889,143 | 889 | | 1,368,391 | | | | 1,369,280 |
| Foreign currency translation adjustment, net of taxes of $-0- | | | | | 67,584 | | | 67,584 |
| Net loss | | | | | | (5,935,632) | | (5,935,632) |
| Balance, August 31, 2006 | 15,740,711 | $ 15,741 | $ | $ 13,056,974 | $ 105,659 | $ 41,040,460 | $ | $ 54,218,834 |

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

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**Dynacq Healthcare, Inc.**

**Consolidated Statements of Cash Flows**

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| **Cash flows from operating activities** | | | |
| Net loss | $ (5,935,632) | $ (5,136,934) | $ (1,608,260) |
| Less income (loss) from discontinued operations, net of income taxes | (3,248,193) | (2,200,323) | 2,714,414 |
| Net loss before discontinued operations | (2,687,439) | (2,936,611) | (4,322,674) |
| Adjustments to reconcile net loss to net cash (used in) provided by operating activities: | | | |
| Extraordinary gain, net of tax | (431,199) | | (198,686) |
| Depreciation and amortization | 2,366,013 | 2,539,208 | 2,639,527 |
| Loss on disposal or impairment of assets | 161,937 | 98,602 | 1,300,000 |
| Gain on settlement of note payable | (226,477) | | |
| Provision for uncollectible accounts | 417,123 | 371,619 | 343,429 |
| Deferred income taxes | (216,813) | 323,143 | 392,177 |
| Minority interests | 129,518 | 10,213 | 222,421 |
| Charge for amending stock options | | 138,015 | 1,085,000 |
| Expense (credit) related to stock options issued to non employees | | (9,482) | (171,353) |
| Deferred stock compensation amortization | | 477,271 | 181,800 |
| Changes in operating assets and liabilities: | | | |
| Restricted cash | (808,708) | | 2,000,000 |
| Accounts receivable | (3,947,337) | 2,878,474 | 6,183,148 |
| Inventories | 297,331 | 526,976 | (476,033) |
| Prepaid expenses | 283,906 | (121,090) | 124,987 |
| Income taxes receivable | 925,792 | 2,866,264 | (1,046,003) |
| Other assets | 30,816 | 160,622 | (532,489) |
| Accounts payable | 1,409,358 | (909,036) | 1,282,111 |
| Accrued liabilities | 1,580,334 | (1,422,117) | (417,004) |
| Income taxes payable | (39,357) | (267,707) | (1,145,150) |
| Cash (used in) provided by continuing activities | (755,202) | 4,724,364 | 7,445,208 |
| Cash (used in) provided by discontinued activities | (2,021,179) | (3,754) | 4,131,315 |
| Net cash (used in) provided by operating activities | (2,776,381) | 4,720,610 | 11,576,523 |
| **Cash flows from investing activities** | | | |
| Proceeds from sale of assets | 10,948 | 4,500 | |
| Purchase of property and equipment | (379,497) | (4,010,229) | (4,980,678) |
| Accrued liabilities related to purchase of property and Equipment | | | (2,425,000) |
| Purchase of accounts receivable-other | | (532,601) | |
| Collections of purchased accounts receivable-other | | 571,354 | |
| Cash used in continuing activities | (368,549) | (3,966,976) | (7,405,678) |
| Cash provided by (used in) discontinued activities | 137,359 | (68,082) | 2,077,635 |
| Net cash used in investing activities | (231,190) | (4,035,058) | (5,328,043) |

Continued.

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**Dynacq Healthcare, Inc.**

**Consolidated Statements of Cash Flows (continued)**

| | Year Ended August 31, | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| **Cash flows from financing activities** | | | |
| Principal payments on notes payable | $ (550,000) | $ (7,785,622) | $ (6,968,225) |
| Proceeds from note payable | 2,491,969 | 5,712,861 | 6,474,917 |
| Proceeds from issuance of restricted stocks | 1,369,280 | | |
| Proceeds from exercise of stock options | | | 500,807 |
| Acquisition of treasury shares | | | (1,611,165) |
| Deposit on proposed sale of accounts receivable | | | 3,360,000 |
| Return of deposit on proposed sale of accounts receivable | | | (3,360,000) |
| Cash overdraft | | (622,375) | 622,375 |
| Contributions from minority interest holders | | 323,518 | 555,000 |
| Distributions to minority interest holders | | (135,750) | (1,457,250) |
| Purchase of minority interests | (130,398) | (251,714) | (570,000) |
| Cash provided by (used in) continuing activities | 3,180,851 | (2,759,082) | (2,453,541) |
| Cash used in discontinued activities | (148,080) | (139,016) | (140,996) |
| Net cash provided by (used in) financing activities | 3,032,771 | (2,898,098) | (2,594,537) |
| Effect of exchange rate changes on cash | 19,297 | 12,605 | |
| Net increase (decrease) in cash and cash equivalents | 44,497 | (2,199,941) | 3,653,943 |
| Cash and cash equivalents at beginning of year | 3,337,835 | 5,537,776 | 1,883,833 |
| Cash and cash equivalents at end of year | $ 3,382,332 | $ 3,337,835 | $ 5,537,776 |
| **Supplemental cash flow disclosures** | | | |
| Cash paid during year for: | | | |
| Interest | $ 392,614 | $ 311,184 | $ 293,558 |
| Income taxes | $ | $ 39,245 | $ 2,057,803 |
| **Non cash investing and financing activities**: | | | |
| Cancellation of treasury stock: | | | |
| Reduction in common stock | $ | $ (1,548) | $ |
| Reduction in additional paid-in capital | | (7,422,901) | |
| Reduction in treasury stock | | 7,424,449 | |
| Land cost | | (604,094) | |
| Transfer of deposit to land | | 604,094 | |
| Land cost from foreign currency gains | (48,287) | (38,075) | |
| Foreign currency gains | 48,287 | 38,075 | |
| Decrease in minority interest from acquisition | | | (350,969) |
| Increase in accrued liabilities due to minority interest acquisition | | | 350,969 |
| | $ | $ | $ |

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

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements**

**August 31, 2006**

**1. Significant Accounting Policies**

**Business and Organization**

Dynacq Healthcare, Inc. is a holding company that through its subsidiaries develops and manages general acute care hospitals that provide specialized general surgeries, such as neuro-spine, bariatric and orthopedic surgeries. Hereinafter, the Company will refer to Dynacq Healthcare, Inc. and its wholly or majority owned subsidiaries, unless the context dictates or requires otherwise.

The Company was incorporated under the laws of the State of Nevada in 1992. The Company was reincorporated in Delaware and its corporate name was changed from Dynacq International, Inc. to Dynacq Healthcare, Inc. in November 2003 to better reflect the Company s business. In connection with the reincorporation in Delaware, the number of authorized common shares was reduced to 100,000,000.

In May 1998, Vista Community Medical Center, L.L.C., a Texas limited liability company, was organized for the purpose of operating a hospital (the Pasadena Facility ). In June 2003, the Pasadena Facility was converted to a limited liability partnership. As of August 31, 2006 and 2005, the Company through its subsidiaries had a 98.5% and 97.0% ownership interest in the Pasadena Facility, respectively.

In March 2001, Vista Surgical Center West, L.L.C., a Texas limited liability company, was organized for the purpose of acquiring and operating Piney Point Surgery Center (the West Houston Facility ). The West Houston Facility is a fully operational ambulatory surgical center in Houston, Texas.

In October 2001, Vista Hospital of Baton Rouge, L.L.C. was organized for the purpose of acquiring and operating a surgical hospital in Baton Rouge, Louisiana (the Baton Rouge Facility ). As of August 31, 2006 and 2005, the Company had a 90% membership interest in the Baton Rouge Facility. On October 8, 2004, the operating subsidiary, VHBR, filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Southern District of Texas. VHBR emerged from bankruptcy and closed this proceeding on August 4, 2005.

In July 2003, Vista Hospital of Dallas, LLP was organized for the purposes of acquiring and operating a surgical hospital in Garland, Texas, (the Garland Facility ). As of August 31, 2006 and 2005, the Company had a 97% membership interest in the Garland Facility.

The Company owns a 70% equity interest in Shanghai DeAn Hospital, a joint venture formed under the laws of the People s Republic of China (the DeAn Joint Venture ). The DeAn Joint Venture entered into land use agreements with the Chinese government for the purpose of constructing a hospital in Shanghai, China that will be owned and operated by the joint venture.

The Company is attempting to locate buyers for the Baton Rouge and West Houston facilities, and real estate owned by it in The Woodlands, Texas.

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly and majority owned subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

**Basis of Presentation**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for annual financial information and with the instructions to Form 10-K and Article 3 and 3-A of Regulation S-X. 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 $10.3 million, $12.0 million and $14.1 million for the fiscal years 2006, 2005 and 2004, respectively.

The Company operates in one line of business, and its strategy is to develop and manage general acute care hospitals that provide principally specialized general surgeries. The Company manages these hospitals on an individual basis. The hospitals economic characteristics, nature of their operations, regulatory environment in which they operate and the way in which they are managed are all similar. The construction of the hospital in China commenced in October 2005, and there were no operations in China for the fiscal year ended August 31, 2006, except for the investment of approximately $4.2 million. Accordingly, the Company aggregates its hospitals into a single reportable segment as that term is defined by Statement of Financial Accounting Standards No. 131 Disclosures About Segments of an Enterprise and Related Information.

**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 the contractual allowance. See Revenue Recognition below for further discussion. Actual results could differ materially from those estimates used in preparation of these financial statements.

**Assets held for Sale**

The Company has made the decision to sell the assets related to its Baton Rouge and West Houston Facilities, and its land at The Woodlands, Texas, and is in the process of retaining the services of brokers to locate buyers. The assets related to these facilities have been classified as Assets held for sale .

**Reclassification**

The assets related to the Baton Rouge and West Houston Facilities and the land in The Woodlands, Texas, and the operating results for these facilities for all periods presented have been reclassified to Assets held for sale and Discontinued Operations.

**Cash and Cash Equivalents**

The Company considers all highly liquid investments 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.

**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.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

**Property and Equipment**

Property and equipment are stated at cost. Maintenance and repairs are charged to expense as incurred. Expenditures which extend the physical or economic life of the assets are capitalized and depreciated.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets ranging from five to 39 years. The Company has classified its assets into three categories. The categories are listed below, along with the useful life and the weighted average useful life for each category.

| | Useful Life | Weighted Average Useful Life |
|---|---|---|
| Land | N/A | N/A |
| Buildings and improvements | 39 years | 39 years |
| Equipment, furniture and fixtures | 5-7 years | 5.1 years |

The Company also leases equipment under capital leases. Such assets are amortized on a straight-line basis over the lesser of the term of the lease or the remaining useful life of the assets.

**Impairment of Long-lived Assets**

The Company routinely evaluates the carrying value of its long-lived assets. The Company records an impairment loss when events or circumstances indicate that a long-lived asset s carrying value may not be recovered. These events may include changes in the manner in which we intend to use an asset or a decision to sell an asset. During fiscal year 2004, the Company determined that the value of land purchased at The Woodlands, Texas had been impaired by $1.3 million. The Company paid approximately $3.1 million for four acres of land (including the cost of a deed restriction, which restricted the use of the surrounding 24 acres to non-medical development). The project to construct a hospital at this site has been discontinued, and since there were no immediate future development plans, the Company had a state certified general real estate appraiser value the land. Based on this valuation, the Company recognized an impairment of the value of the land of $1.3 million in the year ended August 31, 2004.

**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*

Historically, the Company has not participated in managed care contracts. However, during the first quarter of fiscal 2006, the Company began participation in certain managed care contracts and anticipates entering into additional contracts in the future. So far these contracts have not resulted in any meaningful patient revenues. The Company records revenue pursuant to the following 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 the discount (contractual allowance) to arrive at net patient service revenues. Net patient service revenues are based on historical cash collections as discussed below and may not represent amounts ultimately expected to be collected. At such time as the Company can determine that ultimate collections have exceeded or have been less than the revenue recorded on a group of accounts, additional revenue or

reduction in revenue is recorded.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

The table below sets forth the percentage of our gross patient service revenue by financial class for the fiscal years 2006, 2005 and 2004:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Workers Compensation | 54% | 60% | 57% |
| Commercial | 31% | 27% | 30% |
| Medicare | 8% | 5% | 5% |
| Medicaid | 1% | % | % |
| Self-Pay | 4% | 4% | 4% |
| Other | 2% | 4% | 4% |

*Contractual Allowance*

The Company computes its contractual allowance based on the ratio of the Company s historical cash collections during the trailing twelve months on a case-by-case basis by operating facility. This ratio of cash collections to billed services is then applied to the gross billed services by operating facility. The following table shows gross revenues and contractual allowances for fiscal years 2006, 2005 and 2004:

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Gross billed charges | $ 87,365,456 | $ 100,048,950 | $ 91,540,059 |
| Contractual allowance | 51,376,142 | 58,430,799 | 52,306,106 |
| Net revenue | $ 35,989,314 | $ 41,618,151 | $ 39,233,953 |
| Contractual allowance percentage | 59% | 58% | 57% |

*Accounts Receivable*

Accounts receivable represent net receivables for services provided by the Company. The estimated accounts receivable not expected to be collected within twelve months of the balance sheet date have been shown as long-term receivables and represent receivables that are in the MDR process and legal third-party financial class. The contractual allowance is provided as revenue is recognized. At each balance sheet date, management reviews the accounts receivables for collectibility. If after the review management believes certain receivables are uncollectible, the receivables are written down to the expected collectible amount. The following table shows accounts receivable, the contractual allowance, the allowance for uncollectible accounts, net receivables and the contractual allowance as a percent of gross receivables at August 31, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Current portion of gross receivables | $ 77,197,985 | $ 66,838,824 |
| Current portion of contractual allowance | (65,240,225) | (56,449,788) |
| Current portion of allowance for uncollectible accounts | (848,950) | (678,518) |
| Net current portion of accounts receivable | $ 11,108,810 | $ 9,710,518 |
| Contractual allowance and allowance for uncollectible accounts as a percentage of current gross receivables | 86% | 85% |

| | | |
|---|---|---|
| Long term portion of gross receivables | $ 117,437,724 | $ 97,489,085 |
| Long term portion of contractual allowance | (99,246,937) | (82,335,951) |

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

| | 2006 | 2005 |
|---|---|---|
| Long term portion of allowance for uncollectible accounts | (1,291,468) | (989,665) |
| Net long term portion of accounts receivable | $ 16,899,319 | $ 14,163,469 |
| Contractual allowance and allowance for uncollectible accounts as a percentage of long term gross receivables | 86% | 85% |

The contractual allowance stated as a percentage of gross receivables at the balance sheet dates is larger than the contractual 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 contractual allowance. The contractual allowance amounts netted against gross receivables are not adjusted until such time as the final collections on an individual receivable are recognized.

Collections for services provided are generally settled or written off as uncollectible against the contractual allowance within six months of the date of service, except for services provided to injured workers in Texas. Because the Company has in recent years focused on providing services to injured workers in Texas, accounts receivable in the workers compensation MDR process have increased.

The MDR process is an established reimbursement resolution process available to providers of healthcare services under the regulations guiding reimbursement for services provided to injured workers in the state of Texas. Accounts generally do not become subject to the MDR process prior to being outstanding for at least 90 days subsequent to patient discharge. For medical services provided to injured workers in the state of Texas, the MDR process is specifically based upon the administrative and statutory regulations promulgated by the Texas Labor Code, the Texas Administrative Code and the Texas Insurance Code. The Company, in conjunction with most of the Texas hospital medical providers, continues its efforts to resolve the pending claims regarding payment for the treatment of injured workers under the Texas workers compensation laws.

The Company has a significant number of reimbursement disputes where the MDR decision was unsatisfactory to either the insurance carrier or us, and these decisions have subsequently been appealed to the State Office of Administrative Hearings (SOAH) or district court. Many of these cases involve the stop-loss rule governing reimbursement to providers. The Company is pursuing these cases aggressively; however the number of cases that the Company has in the dispute resolution process continues to grow, and payment on many of these cases will not be made until certain standards currently in dispute are established. During the last 30 days, significant activity occurred in the resolution of the legal issues controlling these claims. The Travis County District Court has suggested that it will wait for a decision at SOAH regarding the stop-loss issue. The en banc panel at SOAH recently heard the arguments of both the carriers and providers, but has not yet issued a decision regarding the stop-loss issue. The State Department of Insurance, through the office of the Texas Attorney General, has taken a position at least partially supporting the claims made by the Company and other Texas hospitals.

The delays caused by the unexpected and extended abatements of the SOAH proceedings for both the inpatient and outpatient cases have added significantly to the age of our accounts receivable for these types of services. If these disputes are ultimately resolved against the Company s positions, it will have a material adverse effect on the financial statements.

Due to a number of factors outside the Company s control, including changes in the Company s reimbursement collection experience associated with potential changes in the reimbursement environment in which the Company operates, it is possible that management s estimates of patient service revenues could change, which could have a material impact on the Company s revenue and profitability in the future.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

*Allowance for Uncollectible Accounts*

The Company has estimated uncollectible accounts expense of 1% of gross outpatient revenue. The Company normally makes no charge offs against the allowance for uncollectible accounts, as historically all charge offs have been against the contractual allowance. During the fiscal year ended August 31, 2004, the Company charged $222,518 against the allowance for uncollectible accounts. During the fiscal years ended August 31, 2005 and 2006, the Company made no charge offs against the allowance for uncollectible accounts.

**Stock Based Compensation**

Beginning in the fiscal year 2006, the Company adopted SFAS No. 123(R), Share-Based Payments on a modified prospective transition method to account for its employee stock options. Under the modified prospective transition method, fair value of new and previously granted but unvested equity awards are recognized as compensation expense in the income statement, and prior period results are not restated. Since all of the outstanding stock options were vested as of August 31, 2005, there was no impact on the financials of the Company as a result of the adoption. Had the Company accounted for stock-based compensation plans using the fair value based accounting method described by SFAS No. 123 for the years prior to fiscal year 2006, stock-based compensation costs would have impacted our net loss and loss per common share for the fiscal years ended 2005 and 2004 as follows:

| | 2005 | 2004 |
|---|---|---|
| Net loss as reported | $ (5,136,934) | $ (1,608,260) |
| Add: stock-based compensation costs included in reported net income, net of taxes | 393,773 | 118,170 |
| Deduct: stock based compensation costs, net of taxes under SFAS 123 | (1,000,662) | (567,336) |
| Pro forma net loss | $ (5,743,823) | $ (2,057,426) |
| Per share information: | | |
| Basic, as reported | $ (0.35) | $ (0.11) |
| Basic, pro forma | $ (0.39) | $ (0.14) |
| Diluted, as reported | $ (0.35) | $ (0.11) |
| Diluted, pro forma | $ (0.39) | $ (0.14) |

The fiscal year ended August 31, 2005 included $87,910, net of tax, of future compensation expense that was recognized as a result of the accelerated vesting of stock options and extending the exercise date on a stock option in the fourth quarter of the fiscal year. The Company accelerated the vesting of all then outstanding stock options, primarily to avoid recognizing in its income statement approximately $1.2 million, net of taxes, in associated compensation expense in future periods as a result of the adoption of FASB Statement No. 123R, Share-Based Payment . See also Note 8 Stockholders Equity and Stock Option Plans.

The fair value of the stock-based awards was estimated using the Black-Scholes model with the following weighted average assumptions for fiscal years ended August 31:

| | 2005 | 2004 |
|---|---|---|
| Estimated fair value | $ 4.87 | $ 7.25 |
| Expected life (years) | 4.21 | 4.62 |
| Risk free interest rate | 4.25% | 4.20% |
| Volatility | 93% | 60% |
| Dividend yield | % | % |

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

**Goodwill and Negative Goodwill**

The Company adopted the provisions of SFAS 141, Business Combinations and SFAS 142, Goodwill and Other Intangible Assets, effective September 1, 2002. Upon adoption, the Company discontinued amortization of goodwill and conducted a review for impairment. The Company eliminated negative goodwill as a cumulative effect of a change in accounting principle. SFAS 142 requires that impairment tests be performed at least annually. The impairment tests done upon adoption of the standard and at the end of the fiscal year indicated no impairment of goodwill. During fiscal year 2005, as a result of our recent financial trends and the current outlook for our future operating performance, the Company recorded impairment of goodwill of $98,602.

The changes in the carrying amount of goodwill as of August 31, 2006 and 2005 are as follows:

| | |
|---|---|
| Balance at August 31, 2004 | $ 98,602 |
| Impairment | (98,602) |
| Balance at August 31, 2005 | $ 0 |
| Balance at August 31, 2006 | $ 0 |

**Advertising Costs**

Advertising and marketing costs in the amounts of $5,611,000, $5,012,000 and $4,446,000 for the years ending August 31, 2006, 2005 and 2004, respectively, were expensed as incurred.

**Income Taxes**

The Company uses the liability method in accounting for income taxes. Under this method, deferred tax liabilities or assets are determined based on differences between the income tax basis and the financial reporting basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

**Minority Interests**

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 minority interests. Minority interests 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 interests ranged from 2.14% to 10% at August 31, 2006). During 2004, the Company purchased minority interests from certain minority interest holders at an amount that was $301,040 less than the net book value of the minority interest liability on the date of purchase. The $301,040 gain less applicable income taxes of $102,354 has been recorded as an extraordinary gain during 2004. In addition, the Company had accrued liabilities of $350,969 associated with these minority interest purchases in 2004. This liability is not any longer payable, based on advice from legal counsel, and in 2006 was recorded as an extraordinary gain. During 2005, the Company purchased minority interests from certain minority interest holders at an amount that was $44,516 more than the net book value of the minority interest liability on the date of purchase. The $44,516 loss has been included in Rent and Other Income in the accompanying consolidated statement of operations for the year ended August 31, 2005. During 2006, the Company purchased minority interests from certain minority interest holders at an amount that was $80,230 less than the net book value of the minority interest liability on the date of purchase. The $80,230 gain has been recorded as an extraordinary

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

gain during 2006. The partnership agreement provided a means for the minority interest holders to be cashed out at the net book value of their interests. In 2004, based on advice from legal counsel that the acquisitions were negotiated transactions occurring outside the partnership agreements, the amounts paid to the minority interest holders were less than the buy-out amount that was called for in the partnership agreements. In fiscal 2005 and 2006, the buy-out amounts were made in accordance with the provisions of the various partnership agreements.

The following table sets forth the activity in the minority interest liability account for the fiscal years ending August 31, 2006 and 2005:

| | |
|---|---|
| Balance August 31, 2004 | $ 666,794 |
| Earnings allocated to minority interest holders | 10,213 |
| Acquisition of various minority interests | (207,198) |
| Distribution to minority interest holders | (135,750) |
| Capital contributions received from new minority interest holders | 323,518 |
| | |
| Balance August 31, 2005 | 657,577 |
| Earnings allocated to minority interest holders | 129,518 |
| Acquisition of minority interest | (130,398) |
| | |
| Balance August 31, 2006 | $ 656,697 |

**Net Income Per Share**

Basic net income per share has been computed using the weighted average number of common shares outstanding during the period. Diluted net income per share has been calculated to give effect to the dilutive effect of common stock equivalents consisting of stock options and warrants in years in which the Company has income.

**Foreign Currency Translation**

The Company has designated the Chinese Yuan Renminbi as the functional currency for the DeAn Joint Venture in China. Assets, and liabilities are translated into U.S. dollars using current exchange rates as of the balance sheet date. Income and expense are translated at average exchange rates prevailing during the period. The effects of foreign currency translation adjustments are included as a component of Accumulated Other Comprehensive Income within stockholders equity.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

**Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment ( SFAS No. 123R ). SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options and purchases under employee stock purchase plans, to be recognized as an operating expense in the income statement. The cost is recognized over the requisite service period based on fair values measured on grant dates, and the new standard may be adopted using either the modified prospective transition method or the modified retrospective transition method. In April 2005, the SEC approved a change in the effective date of SFAS No. 123R for public companies to be effective in the annual, rather than interim, periods beginning after June 15, 2005. SFAS No. 123R was effective for us beginning September 1, 2005. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB No. 107 ) Share-Based Payment , which expresses views of the SEC regarding the interaction between SFAS No. 123R and certain SEC rules and regulations. SAB No. 107 also provides the SEC s views regarding the valuation of share-based payment arrangements for public companies. We have evaluated the requirements of SAB No. 107 in connection with our adoption of SFAS No. 123R and expect that these new pronouncements will have a material impact on our results of operations for future employee stock options granted. The new guidance did not have an impact on our options outstanding as of August 31, 2006, as we had accelerated the vesting of these options in fiscal year ended August 31, 2005.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that we recognize in our financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 will be effective for us for fiscal year 2008, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on our consolidated financial statements.

**2. Property and Equipment**

At August 31, property and equipment consisted of the following:

| | 2006 | 2005 |
|---|---|---|
| Land | $ 6,029,304 | $ 5,883,616 |
| Buildings and improvements | 13,954,662 | 14,034,547 |
| Equipment, furniture and fixtures | 14,928,781 | 15,054,306 |
| | 34,912,747 | 34,972,469 |
| Less accumulated depreciation and amortization | (13,497,020) | (11,308,059) |
| Construction in progress | 142,473 | |
| Net property and equipment | $ 21,558,200 | $ 23,664,410 |

For the years ended August 31, 2006, 2005, and 2004, depreciation expense was $2,356,013, $2,529,208 and $2,623,527, respectively.

**3. Assets held for sale**

On February 21, 2006, the Company entered into an agreement to sell the Baton Rouge Facility, but the transaction was not consummated and the sales agreement terminated on March 7, 2006. The Company has determined to sell the Baton Rouge and West Houston Facilities, and its land in The Woodlands, Texas, and is in the process of retaining the services of brokers to locate buyers. The assets related to these facilities have been classified as Assets held for sale . None of these assets is encumbered by secured lien or debt.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

During fiscal year 2004, the Company sold land in Slidell, Louisiana to a Nevada limited liability company of which a former executive officer of the Company was a member. The Company decided not to develop this hospital in Louisiana because it did not fit the Company s business plan. On January 23, 2004, the property was sold and the Company recognized a gain of $318,366, which is recorded as Rent and Other Income in the accompanying consolidated statement of operations for the year ended August 31, 2004.

**4. Discontinued operations**

In 2006, the Company decided to sell the assets related to the Baton Rouge and West Houston Facilities, since those operations were not core to our long-term objectives, and are not performing consistently with the expectations the Company had for them at the time investments were made. The Company has also made the decision to sell its land in The Woodlands, Texas, since it no longer intends to build on that site. None of those assets is encumbered by secured lien or debt, so all proceeds from the sale of any of those assets, net of selling expenses, would be available to pay down the existing revolving credit facility which is based on eligible accounts receivable, improve liquidity for the Company s day-to-day operations, and invest in the Company s core business activities, including the China Project.

The Company has accounted for its Baton Rouge and West Houston Facilities as discontinued operations, and has reclassified prior period financial statements to exclude these businesses from continuing operations. A summary of financial information related to the Company s discontinued operations for each of the past three years is as follows:

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Net patient service revenue | $ 9,342,985 | $ 13,656,710 | $ 23,615,425 |
| Costs and expenses | (12,992,208) | (17,115,888) | (19,635,897) |
| Other income | 82,240 | 40,199 | 321,747 |
| Income (loss) before income taxes | (3,566,983) | (3,418,979) | 4,301,275 |
| Benefit (provision) for income taxes | 318,790 | 1,218,656 | (1,586,861) |
| Income (loss) from discontinued operations, net of income taxes | $ (3,248,193) | $ (2,200,323) | $ 2,714,414 |

Assets and liabilities of discontinued operations related to the Baton Rouge and West Houston Facilities, and the land in The Woodlands, Texas, consist of the following as of August 31, 2006 and 2005:

| | August 31, | |
|---|---|---|
| | 2006 | 2005 |
| Property and equipment, net | $ 13,252,800 | $ 14,899,216 |
| Total assets | $ 13,252,800 | $ 14,899,216 |
| Capital lease obligations | $ 130,299 | $ 278,379 |
| Total liabilities | $ 130,299 | $ 278,379 |

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

**5. Notes payable**

At August 31, notes payable consisted of the following:

| | 2006 | 2005 |
|---|---|---|
| Note payable to former owners of the Garland Facility, past due together with interest at the rate of a major banks prime plus 1% | $ | $ 670,000 |
| Five-year revolving credit facility with a financial institution subject to a borrowing base based on eligible accounts receivable, secured by a first priority security interest in all existing and future accounts receivable and accounts receivable related items, other assets and deposit accounts of certain subsidiaries, a pledge of 75% of equity interest in the operating entities of the Garland and Pasadena Facilities and a negative pledge for the equity interests in the Company and other subsidiaries, variable interest payable of 2.85% plus LIBOR rate. The effective interest rate at August 31, 2006 was 8.18%. | 6,339,212 | 3,847,243 |
| | $ 6,339,212 | $ 4,517,243 |

The balance owed under the five-year revolving Credit Agreement as of November 7, 2006 was $6,265,106.

**6. Income Taxes**

The benefit for income taxes consisted of the following:

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Current tax expense (benefit): | | | |
| Federal | $ | $ 165,289 | $ (621,600) |
| State | | (102,887) | 75,158 |
| Total current | | 62,402 | (546,442) |
| Deferred tax expense (benefit): | | | |
| Federal | (310,503) | (132,474) | (749,784) |
| State | | 64,026 | (51,743) |
| Total deferred | (310,503) | (68,448) | (801,527) |
| Total income tax benefit | $ (310,503) | $ (6,046) | $ (1,347,969) |

As of August 31, 2006, 2005 and 2004, income tax benefits of $-0-, $-0- and $46,760, respectively, resulting from deductions relating to nonqualified stock option exercises and disqualifying dispositions of certain employee incentive stock options were recorded as increases in stockholders equity.

The components of the provision for deferred income taxes at August 31 were as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Applicable to: | | | |
| Differences between revenues and expenses recognized for federal income tax and financial reporting purposes | $ | $ 707,639 | $ |
| Stock options and related employee compensation | | 233,035 | 143,236 |
| Allowance for uncollectible accounts | (153,589) | (134,438) | (38,521) |

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Asset impairment | | (274,487) | (442,000) |
| Difference in method of computing depreciation for tax and financial reporting purposes | (360,763) | (233,495) | 691,469 |
| Net operating loss carry forward | (702,752) | | |
| Valuation allowance | 870,277 | | |
| Losses from continuing operations used to offset gains from discontinued operations | | | (1,370,872) |
| Other | 36,324 | (366,702) | 215,161 |
| | $ (310,503) | $ (68,448) | $ (801,527) |

Significant components of the Company s deferred tax liabilities and assets were as follows at August 31, 2006:

| | Current | Noncurrent |
|---|---|---|
| Deferred tax liabilities: | | |
| Depreciation | $ | $ (1,154,811) |
| Deferred tax assets: | | |
| Revenue and expense differences | (459,982) | |
| Allowance for uncollectible accounts | 793,538 | |
| Asset impairment | | 716,487 |
| Net operating loss | 1,646,597 | |
| Valuation allowance | (2,009,375) | 245,595 |
| Other | 29,222 | |
| Minority interest | | 192,729 |
| Net deferred tax asset (liability) | $ | $ |

Significant components of the Company s deferred tax liabilities and assets were as follows at August 31, 2005:

| | Current | Noncurrent |
|---|---|---|
| Deferred tax liabilities: | | |
| Depreciation | $ | $ (1,777,426) |
| Deferred tax assets: | | |
| Revenue and expense differences | (424,229) | |
| Allowance for uncollectible accounts | 620,490 | |
| Asset impairment | | 716,487 |
| Other | 26,940 | 15,858 |
| Minority interest | | 192,587 |
| Net deferred tax asset (liability) | $ 223,201 | $ (852,494) |

A reconciliation of the benefit for income taxes with amounts determined by applying the statutory federal income tax rate to loss before income taxes, minority interests and extraordinary gain is as follows:

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Benefit for income taxes computed using the statutory rate of 35% | $ (1,154,868) | $ (1,026,355) | $ (1,976,418) |
| State income taxes, net of federal benefit | | (102,883) | 63,223 |
| Minority interests in subsidiaries income | (77,634) | (68,270) | 45,953 |
| Non-deductible expenses applicable to employee stock options | | 427,093 | 530,855 |

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

| | | | |
|---|---|---|---|
| Change in valuation allowance | 870,277 | | |
| Other | 51,722 | 764,369 | (11,582) |
| Benefit for income taxes | $ (310,503) | $ (6,046) | $ (1,347,969) |

Tax loss carryforwards of approximately $4,700,000 generated in fiscal year 2006 begin expiring in fiscal year 2026.

**7. Related Party Transactions**

During fiscal year 2005, the Company entered into an agreement with Redwood Health Corporation ( Redwood ), to furnish physicians to provide in-house emergency medical coverage for its Pasadena Facility during the weekend hours and weekday nights at an hourly rate of $75. The Company s Chief Executive Officer s son who is a physician is an affiliate of Redwood. The Company paid $207,225 and $46,800 for such services to Redwood in fiscal 2006 and 2005, respectively. Management, as well as the Audit Committee that approved the agreement, believes that the hourly rate being paid is consistent with comparable in-house emergency medical coverage rates available in the area.

The Company leases 7,250 square feet of office space for its executive offices through September 1, 2011 for $6,525 per month. The lessor of the office space is Capital Bank, of which Mr. Earl Votaw, one of the Company s directors, is a director. Management believes that the lease rate being paid is consistent with comparable commercial rates available in the area.

Dr. Ping Chu, a director, has paid the Company $28,633, $28,840 and $27,340 during fiscal years ended August 31, 2006, 2005 and 2004, respectively for rent and management fees. As of August 31, 2006 and 2005, the Company had accounts receivable from Dr. Chu of $12,016 and $28,185, respectively. Included in the accounts receivable balance were amounts applicable to Dr. Chu s staffs payroll for which he reimburses the Company in the ordinary course of business.

**8. Stockholders Equity and Stock Option Plans**

*Private placement*

In May 2006, the Company offered for sale shares of its common stock to a limited number of accredited investors in a private placement at a purchase price of $1.54 per share, which was 70% of the market price of Company stock on the offering date. A total of 889,143 shares were sold, resulting in sales proceeds of $1,369,280. The shares are restricted securities which may not be offered or sold publicly in the United States except pursuant to the effectiveness of a registration statement or an applicable exemption from the registration requirements of the Securities Act. The sales proceeds were used to meet the cash needs of the Company s day-to-day operations.

*Preferred Stock*

In January 1992, the board of directors approved an amendment to the Company s Articles of Incorporation to authorize 5,000,000 shares of undesignated preferred stock, for which the board of directors is authorized to fix the designation, powers, preferences and rights. There are no shares of preferred stock issued or outstanding as of August 31, 2006.

In February 2003, the Board of Directors designated 200,000 shares of the undesignated preferred stock as Series A Preferred Stock and declared a stock dividend equal to one share of Series A Preferred Stock for every full block of 100 shares of common stock. The Series A Preferred Stock could either be redeemed for cash at $14.50 per share or if not redeemed by June 10, 2003, would be automatically converted into one share of the Company s common stock. As a result of this action the Company redeemed 32,656 shares for cash in the amount of $473,511 (which has been shown in the accompanying statement of stockholders equity as a preferred stock redemption) and issued 129,577 shares of common stock in conversion of the unredeemed Series A Preferred Stock.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

*Treasury Stock*

Pursuant to the Company s announced 500,000 common stock buy-back program in January 2002, the Company bought back 103,176; 261,500; and, 86,000 shares of its common stock in fiscal years 2004, 2003 and 2002, respectively, at an average cost of $14.08 per share, for a total purchase price of $6,345,680. On August 31, 2005, the Board of Directors retired and cancelled all of the 1,548,275 shares of common stock held as treasury stock.

*Stock Option Plans*

The Company s 1995 Non-qualified Plan and the 2000 Incentive Plan (the Plans ) provide 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 6,000,000 shares of common stock for future issuance under the Plans. As of August 31, 2006, there remains 3,408,336 shares which can be issued under the Plans, after giving effect to stock splits and shares issued under the Plans. All awards previously granted to employees under the Plans have been stock options, primarily intended to qualify as incentive stock options within the meaning of Section 422 of the Internal Revenue Code (the Code ). The Plans also permit stock awards, stock appreciation rights, performance units, and other stock-based awards, all of which may or may not be subject to the achievement of one or more performance objectives.

The purposes of the Plans generally are to retain and attract persons of training, experience and ability to serve as employees of the Company and its subsidiaries and to serve as non employee directors of the Company, to encourage the sense of proprietorship of such persons and to stimulate the active interest of such persons in the development and financial success of the Company and its subsidiaries.

The Plans are administered by the Compensation Committee of the board of directors (the Committee ). The Committee has the power to determine which eligible employees will receive awards, the timing and manner of the grant of such awards, the exercise price of stock options (which may not be less than market value on the date of grant), the number of shares, and all of the terms of the awards. The Company may at any time amend or terminate the Plans. However, no amendment that would impair the rights of any participant with respect to outstanding grants can be made without the participant s prior consent. Stockholder approval of an amendment to the Plans is necessary only when required by applicable law or stock exchange rules.

The following summarizes stock option activity and related information:

| | Year Ended August 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | |
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| | (Share Amounts In Thousands) | | | | | |
| Outstanding beginning of year: | 1,491 | $ 5.27 | 1,013 | $ 8.92 | 1,201 | $ 8.25 |
| Granted | | | 1,051 | 4.91 | | |
| Exercised | | | | | (106) | 4.75 |
| Canceled | (473) | 4.66 | (573) | 11.07 | (82) | 4.44 |
| Outstanding end of year | 1,018 | $ 5.55 | 1,491 | $ 5.27 | 1,013 | $ 8.92 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Exercisable end of year | 1,018 | $ | 5.55 | 1,491 | $ | 5.27 | 638 | $ 6.38 |

The following summarizes information related to stock options outstanding at August 31, 2006:

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Shares | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| | (Share Amounts In Thousands) | | | | |
| $ 4.44 5.00 | 917 | 7.4 | $ 4.81 | 917 | $ 4.81 |
| $12.25 | 101 | 1.7 | 12.25 | 101 | 12.25 |
| Total | 1,018 | 6.8 | $ 5.55 | 1,018 | $ 5.55 |

On April 15, 2002, the Company granted an employee an option that was in the money on the date of grant. The difference in the market value on the exercise date and the grant price on the grant date was $909,000, which had been recorded as deferred compensation expense and was being amortized to expense over the vesting period of 5 years. During fiscal year 2005, the remaining balance of deferred compensation was amortized to expense since the employee was no longer employed with the Company. Amortization expense of $-0-, $477,271 and $181,800 has been recorded as compensation expense in the years 2006, 2005 and 2004, respectively.

During the fiscal year ended August 31, 2002, the Company granted stock options to non-employees. The fair value of such stock options (calculated using the Black Scholes model) has been charged to expense with a corresponding credit to additional paid-in capital. The Company recorded expense or credit associated with stock options issued to non employees of $-0-, $(9,482) and $(171,353) during the three year period ended August 31, 2006. During October 2002, the Company issued warrants to acquire 61,149 shares of the Company s common stock at a price of $10.95 per share. The warrants vested immediately and were exercisable through October 2005. The value of the warrants using the Black Scholes pricing model was calculated to be $327,758 which was charged to expense and credited to additional paid-in capital in fiscal year 2003. The warrants were subsequently returned to the Company, and since they vested immediately no reversal of the compensation expense was recorded.

During the fiscal year ended August 31, 2004, the Company amended a stock option issued previously to an employee of the Company, which led to a non-cash pre-tax charge of $1,085,000.

During the fiscal year ended August 31, 2005, the Company granted various stock options to employees. On December 16, 2004, the Compensation Committee of the Board of Directors granted stock options to full time employees (other than the executive officers) of the Company and its subsidiaries, such grants totaling 933,000 shares of common stock, vesting in each of the subsequent four years on the anniversary date of the grant, and having an exercise price of $4.90 per share. On January 4, 2005, the Compensation Committee granted stock options to two full time employees (not executive officers) of the Company and its subsidiaries, such grants totaling 3,000 shares of common stock, vesting in each of the subsequent four years on the anniversary date of the grant, and having an exercise price of $5.00 per share. On January 17, 2005, the Compensation Committee granted 100,000 stock options to an executive officer of the Company, vesting in each of the subsequent four years on the anniversary date of the grant, and having an exercise price of $5.00 per share. On August 31, 2005, the Compensation Committee granted 15,000 stock options to one full time employee (not executive officer) of the Company and its subsidiaries, vesting immediately on date of grant, and having an exercise price of $4.96 per share.

On August 31, 2005 the Compensation Committee accelerated the vesting of all then outstanding stock options, and extended the exercise date of a stock option for an executive officer, primarily to avoid recognizing in its income statement approximately $1,874,000 in associated

compensation expense in future periods, of which approximately $824,000 would have been recognized in fiscal year 2006 as a result of the adoption of SFAS No. 123R. Unvested stock options to purchase 979,173 shares, of which 100,000 are held by an executive officer, became exercisable as a result of the vesting acceleration. The Compensation Committee also extended the exercise date for vested stock options to purchase 197,500

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

shares held by another executive officer of the Company. The Company recorded approximately $138,000 non-cash compensation charge as a result of these actions, of which approximately $35,000 is related to the excess of the intrinsic value over the fair market value of the Company s stock on the acceleration date of those options that would have been forfeited or expired unexercised had the vesting not been accelerated, and approximately $103,000 is related to the excess of the intrinsic value over the fair market value of the Company s stock on the date of extension of the exercise date of those options that would have been forfeited or expired unexercised had the exercise date not been extended. In determining the forfeiture rates of the stock options, the Company reviewed the current employee turnover rate, the unvested options original life, time remaining to vest and whether these options were held by officers of the Company. The compensation charge will be adjusted in future period financial results as actual forfeitures are realized.

**9. Employee Benefit Plan**

The Company sponsors a 401(k) defined contribution plan covering substantially all employees of the Company and provides for voluntary contributions by these employees, subject to certain limits. The plan was effective June 1, 2001. The Company makes discretionary contributions to the plan. The Company s contributions for fiscal years 2006, 2005 and 2004 were $54,814, $50,764 and $44,894, respectively.

**10. Net Income Per Share**

The numerator used in the calculations of both basic and diluted net income per share for all periods presented was net income. The shares outstanding for basic and diluted are the same, as an increase in the number of shares for dilution purposes would be anti-dilutive. The denominator for each period presented was determined as follows:

| | Year Ended August 31, | | |
|---|---|---|---|
| | 2006[1] | 2005[1] | 2004[1] |
| Denominator: | | | |
| Basic net income per share weighted average shares outstanding | 15,088,227 | 14,851,568 | 14,849,526 |
| Effect of dilutive securities: | | | |
| Common stock options treasury stock method | | | |
| Diluted net income per share weighted average shares outstanding | 15,088,227 | 14,851,568 | 14,849,526 |

(1) Fully diluted shares would have been 15,094,531, 14,924,578 and 15,161,523 for the years ended August 31, 2006, 2005 and 2004, respectively, if they had not been anti-dilutive.

**11. Comprehensive Loss**

Comprehensive loss at August 31 is as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Net loss | $ (5,935,632) | $ (5,136,934) | $ (1,608,260) |
| Foreign currency translation adjustment, net of $-0- and 19,615 taxes, in fiscal years 2006 and 2005, respectively | 67,584 | 38,075 | |
| Comprehensive loss | $ (5,868,048) | $ (5,098,859) | $ (1,608,260) |

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

**12. Accrued Liabilities**

Accrued liabilities at August 31 is as follows:

| | 2006 | 2005 |
|---|---|---|
| Payroll and related taxes | $ 862,594 | $ 958,501 |
| Lawsuit settlements and other related expenses | 1,885,000 | 385,000 |
| Property taxes | 462,043 | 469,530 |
| Medicare liability | 400,000 | |
| Payable to minority interest holder | | 350,969 |
| Insurance premium payable | 121,242 | 176,151 |
| Accrued interest | 44,507 | 110,246 |
| Year-end accruals of expenses and other | 838,200 | 1,040,302 |
| Total accrued liabilities | $ 4,613,586 | $ 3,490,699 |

**13. Commitments and Contingencies**

**Leases**

Future minimum payments, by year and in the aggregate, required under noncancellable operating leases for certain facilities and equipment consist of the following at August 31, 2006:

| Year ending August 31 | Operating Leases |
|---|---|
| 2007 | $ 432,226 |
| 2008 | 258,483 |
| 2009 | 149,281 |
| 2010 | 115,551 |
| 2011 | 78,300 |
| Thereafter | 19,575 |
| | $ 1,053,416 |

Total rent and lease expenses paid by the Company for the fiscal years 2006, 2005 and 2004 were approximately $1,061,000, $1,218,000 and $1,005,000, respectively.

In the first quarter of fiscal 2006, the Company, through its subsidiary, also had agreements with outside organizations that offer marketing, pre-authorization and follow up support services to prospective bariatric and orthopedic patients in areas serviced by the Pasadena and Garland Facilities. These facilities received bariatric and orthopedic referrals from other sources, and the organizations referred clients to other area hospitals. Payments made related to these agreements for the fiscal years 2006, 2005 and 2004 were $5,187,000, $4,993,000 and $4,150,000, respectively.

The Company has contracts with doctors to manage various areas of the Company s hospitals and other service agreements. Payments made under these agreements for the fiscal years ending August 31, 2006, 2005 and 2004 were $3,686,000, $4,820,000 and $3,010,000, respectively. Future minimum payments under the terms of these contracts and agreements for the following fiscal years are: 2007, $1,087,316; 2008, $70,421; 2009, $9,636; and for 2010, $1,606.

*Discontinued operations commitments*

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

For the Company s discontinued operations, the future minimum rental commitments under noncancellable leases for the following fiscal years are: 2007, $823,598; and for 2008, $679,445. Future minimum payments under the terms of contracts and agreements with doctors and other service agreements for the following fiscal years are: 2007, $1,012,413; 2008, $512,359; and for 2009, $226,218. There is also an obligation of $134,104 (including interest) payable in 2007 under a capital lease for medical equipment.

**Risks and Uncertainties**

The Company maintains various insurance policies that cover each of its facilities. Specifically, the Company has claims-made malpractice coverage for its West Houston Facility and occurrence coverage for its Pasadena and Garland Facilities. In Louisiana, the Company is a member of the Louisiana Patient Compensation Fund and purchases insurance through the Louisiana Patient Compensation Fund for medical malpractice. In addition, all physicians granted privileges at the Company s facilities are required to maintain medical malpractice insurance coverage. The Company also maintains general liability and property insurance coverage for each facility, including flood coverage. The Company maintains workers compensation coverage for the Baton Rouge Facility, but does not currently maintain worker s 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.

In the second quarter of 2004, eight class action lawsuits were filed in the United States District Court for the Southern District of Texas alleging federal securities law causes of action against the Company and various current and former officers and directors. The plaintiffs were persons who purchased shares of the Company s common stock on the open market generally during the period of January 14, 2003 through December 18, 2003. Under the procedures of the Private Securities Litigation Reform Act, the Court consolidated the actions and appointed lead plaintiffs in the matter. An amended complaint was filed on June 30, 2004, asserting a class period of November 27, 2002, through December 19, 2003 and naming additional defendants, including Ernst & Young, LLP, the Company s prior auditors. The amended complaint sought certification as a class action and alleged that the defendants violated Sections 10(b), 20(a), 20(A), and Rule 10b-5 under the Exchange Act by publishing materially misleading financial statements that did not comply with generally accepted accounting principles, making materially false or misleading statements or omissions regarding revenues and receivables, operations and financial results, and engaging in an intentional fraudulent scheme aimed at inflating the value of Dynacq s stock. After the Company filed its Form 10-K for fiscal 2003 on July 30, 2004, the plaintiffs filed a Second Amended Consolidated Class Action Complaint on September 30, 2004. All defendants filed motions to dismiss the complaint. The plaintiffs voluntarily dismissed two of the former officers from the case. The Court dismissed the claims against one former officer and Ernst & Young, LLP, but denied the motions to dismiss the Company and two current officers who are defendants. The parties reached a settlement agreement in principle in August 2006 for $1.5 million, and on October 10, 2006 the parties signed a Stipulation of Settlement setting forth the terms of their proposed settlement of the action. The settlement provides for Dynacq to pay $100,000 within 30 days of final approval of the settlement by the court and to issue a note for $1.4 million to be paid in 36 equal monthly installments beginning 30 days thereafter. The note shall bear interest at 6% per annum and be secured by a deed of trust on the Garland Facility. As a result of this settlement, the Company recorded a $1.5 million charge to operations during 2006. The settlement contains provisions releasing the Company, its two executive officers named as defendants and its subsidiaries from liability and prohibiting the filing of any future claims by the members of the class relating to this matter. Dynacq and its current and former officers and directors did not admit liability or fault for the matters alleged in the lawsuit. On October 18, 2006, the Court signed an order preliminarily approving the settlement, preliminarily certifying the class, and approving the form and substance of the notice to class members. A settlement hearing will be held on January 10, 2007 to determine (a) whether the settlement is fair, reasonable and adequate and should be approved by the court; (b) whether an Order of Final Judgment and Dismissal should be entered; and (c) whether the Fee and Expense Application of plaintiffs counsel should be approved.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

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 facility s fees must be made in the district courts of Travis County, Texas in what can often be a lengthy procedure.

**14. Concentrations of Credit Risk and Fair Value of Financial Instruments**

The Company has financial instruments that are exposed to concentrations of credit risk and consist primarily of cash investments and trade accounts receivable. The Company routinely maintains cash and temporary cash investments at certain financial institutions in amounts substantially in excess of FDIC and Securities Investor Protection Corporation ( SIPC ) insurance limits; however, management believes that these financial institutions are of high quality and the risk of loss is minimal. At August 31, 2006, the Company had cash balances in excess of the FDIC and SIPC limits of $4,984,877.

As is customary in the healthcare business, the Company has accounts receivable from various third-party payers. The Company does not request collateral from its customers and continually monitors its exposure for credit losses and maintains allowances for anticipated losses. Receivables from third -party payers are normally in excess of 90% of the total receivables at any point in time. The mix of gross receivables from self-pay patients and third-party payers at August 31, 2006 and 2005 is as follows:

| | 2006 | 2005 |
|---|---|---|
| Workers compensation | 10% | 14% |
| Workers compensation subject to Medical Dispute Resolution process | 73% | 70% |
| Commercial | 8% | 8% |
| Medicare | 3% | 2% |
| Medicaid | % | % |
| Self-pay | 3% | 2% |
| Other | 3% | 4% |
| | 100% | 100% |

We had no third-party payer (customer) representing greater than 10% of the Company s gross revenue for the years ended August 31, 2006, 2005 and 2004. We had one third-party payer (customer) who represented 13% of our gross receivables as of August 31, 2006 and 2005.

The carrying amounts of cash and cash equivalents, current receivables, accounts payable and accrued liabilities approximate fair value due to the short-term nature of these instruments. The carrying amounts of the Company s short-term borrowings at August 31, 2006 and 2005 approximate their fair value.

**15. China Project**

On May 16, 2005, the DeAn Joint Venture, of which the Company owns a 70% equity interest, entered into land use agreements with the Chinese government to lease for a term of 50 years approximately 28.88 acres of government-owned land in Shanghai, China. The land is to be used for the China Project.

In accordance with the Land Use Right Agreement, construction of the peripheral walls commenced in October 2005, and the DeAn Joint Venture is currently negotiating a contract for the construction of the hospital. If the hospital is not completed on or before November 16, 2008, the land authority may revoke the land use right without compensation to the DeAn Joint Venture and take over all constructions and fixtures on the land. The DeAn Joint Venture may apply to the Jiading Land Bureau for an extension upon the expiration of the land use right, provided that the joint venture has extended its business license over 50 years. If the extension for the land use right is approved by the Land Bureau, the joint venture will need to sign renewed land use right agreements and pay land premiums as required by the Land Bureau. If the joint venture does not

apply for an extension of the land use right or the application is rejected, the land use

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

right, as well as the buildings and other site equipment, would be taken back by the government without payment. The Company is currently required to make contributions to the DeAn Joint Venture of approximately $8.7 million before June 2, 2007 (previously reported as March 31, 2007). Approximately $4.3 million of such amount has been paid by the Company to the DeAn Joint Venture. The Company was required to make a contribution to the DeAn Joint Venture of approximately $2.2 million on June 2, 2006 (previously reported to be due March 31, 2006). That payment was not made, resulting in a technical default under the Joint Venture Agreement. Dynacq has received no notice of default under the Joint Venture Agreement or demand for this payment, and the Chinese government has not yet made payments due by it under the Joint Venture Agreement. The remedies for failure to make a payment under the Joint Venture Agreement are that the venturer will lose its right to vote on joint venture matters and may need to provide additional capital in order for the joint venture to maintain its qualification to do business. The Company is negotiating with the Chinese government for a new timetable for the payment by both joint venturers of the amounts due under the Joint Venture Agreement or for the sale by the government of its interest in the DeAn Joint Venture to a third party.

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**August 31, 2006**

**16. Quarterly Financial Data (reviewed)**

| | Quarters Ended | | | |
|---|---|---|---|---|
| | **November 30** | **February 28** | **May 31** | **August 31** |
| **2006** | | | | |
| Revenues | $ 9,673,790 | $ 8,338,667 | $ 7,831,450 | $ 10,145,407 |
| Loss from continuing operations[1] | (540,002) | (689,790) | (397,298) | (1,491,548) |
| Discontinued operations, net of income taxes[2] | (959,223) | (1,660,989) | (420,814) | (207,167) |
| Extraordinary gain, net of income taxes | | | | 431,199 |
| Net loss | (1,499,225) | (2,350,779) | (818,112) | (1,267,516) |
| Basic and diluted loss per common share: | | | | |
| Loss from continuing operations | (0.04) | (0.05) | (0.03) | (0.10) |
| Net loss | (0.10) | (0.16) | (0.05) | (0.08) |
| **2005** | | | | |
| Revenues | $ 10,473,134 | $ 10,608,347 | $ 9,974,351 | $ 10,562,319 |
| Loss from continuing operations[3] | (647,426) | (650,080) | (1,228,129) | (410,976) |
| Discontinued operations, net of income taxes[4] | 370,252 | (1,011,925) | 314,947 | (1,873,597) |
| Net loss | (277,174) | (1,662,005) | (913,182) | (2,284,573) |
| Basic and diluted loss per common share: | | | | |
| Loss from continuing operations | (0.04) | (0.04) | (0.08) | (0.03) |
| Net loss | (0.02) | (0.11) | (0.06) | (0.16) |

(1) Loss from continuing operations is primarily due to decreased net patient revenue in the first three quarters of the year. The fourth quarter of fiscal year 2006 had increased loss from continuing operations due to a $1.5 million expense for class action lawsuit settlement.

(2) Discontinued operations had a higher loss in the second quarter of fiscal year 2006 primarily due to lower net patient service revenues, with the costs and expenses not decreasing proportionately.

(3) The third quarter of fiscal year 2005 had increased losses primarily due to lower revenues and decreased rent and other income.

(4) The second quarter of fiscal year 2005 incurred loss from discontinued operations due to increased legal and other operating expenses associated with the bankruptcy filing of VHBR. The loss in the second quarter was higher also due to a $400,000 settlement expense related to the Liljeberg lawsuit. The fourth quarter loss includes a goodwill impairment charge of $483,945.

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**Dynacq Healthcare, Inc.**

**Schedule II Valuation and Qualifying Accounts[1]**

**For the Years Ended August 31, 2006, 2005 and 2004**

| | Balance at Beginning of Period | Charged to Costs and Expenses | Charged to Other Accounts[2] | Deductions[3] | Balance at End of Period |
|---|---|---|---|---|---|
| **2006** | | | | | |
| Contractual allowances | $ 138,785,739 | $ | $ 61,677,882 | $ (35,976,457) | $ 164,487,164 |
| Allowance for uncollectible accounts[4] | 1,668,182 | 417,123 | 55,112[5] | | 2,140,417 |
| **2005** | | | | | |
| Contractual allowances | $ 128,181,297 | $ | $ 69,888,416 | $ (59,283,974) | $ 138,785,739 |
| Allowance for uncollectible accounts[4] | 1,201,765 | 371,619 | 94,798[5] | | 1,668,182 |
| **2004** | | | | | |
| Contractual allowances | $ 98,162,339 | $ | $ 65,374,813 | $ (35,355,855) | $ 128,181,297 |
| Allowance for uncollectible accounts[4] | 956,392 | 343,429 | 124,462[5] | (222,518) | 1,201,765 |

(1) This schedule includes the contractual allowances and allowances for uncollectible accounts related to the Company s discontinued operations, since the related Accounts Receivable are not being sold.

(2) The amounts charged to contractual allowance are 58%, 56% and 51% of gross billed charges for fiscal years 2006, 2005 and 2004, respectively.

(3) Reflects adjustment to the contractual allowance upon receipt of cash and settlement of accounts receivable. When cash is received for a particular account receivable and the Company considers the cash payment to be the final settlement of the account balance, the gross receivable is eliminated and the contractual allowance is reduced by the difference between the gross receivable and the cash collected.

(4) The Company currently estimates uncollectible accounts expense on a monthly basis of 1% of gross outpatient revenue. The Company normally makes no charge offs against the allowance for uncollectible accounts, as historically all charge offs have been against the contractual allowance. During the fiscal year ended August 31, 2004, the Company charged $222,518 against the allowance for uncollectible accounts. During the fiscal years ended August 31, 2005 and 2006, the Company made no charge offs against the allowance for uncollectible accounts.

(5) This amount represents the uncollectible accounts estimate for the discontinued operations of the Company.

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

None.

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

Internal Control over financial reporting, no matter how well designed, has inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation to assess the effectiveness of our internal control over financial reporting as of August 31, 2006. Based on that evaluation, we believe that, as of August 31, 2006, our internal control over financial reporting is effective.

Subsequent to the evaluation and through the date of this filing of Form 10-K for fiscal year 2006, there have been no significant changes in our internal controls or in other factors that have materially affected, or are reasonably likely to materially affect, our internal controls. Previously noted weaknesses have been corrected.

**Item 9B. Other Information**

None.

**PART III**

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

The information required by this Item 10 is incorporated by reference from the Company s Definitive Proxy Statement for our 2007 annual meeting to be filed on or before December 29, 2006.

**Item 11. Executive Compensation.**

The information required by this Item 11 is incorporated by reference from the Company s Definitive Proxy Statement for our 2007 annual meeting to be filed on or before December 29, 2006.

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

The information required by this Item 12 is incorporated by reference from the Company s Definitive Proxy Statement for our 2007 annual meeting to be filed on or before December 29, 2006.

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

The information required by this Item 13 is incorporated by reference from the Company s Definitive Proxy Statement for our 2007 annual meeting to be filed on or before December 29, 2006.

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

The information required by this Item 14 is incorporated by reference from the Company s Definitive Proxy Statement for our 2007 annual meeting to be filed on or before December 29, 2006.

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**PART IV**

**Item 15. Exhibits and Financial Statement Schedules.**

(a)(1) Financial Statements: See Index to Consolidated Financial Statements under Item 8 on Page 39 of this Report.

(a)(2) Financial Statement Schedule: See Schedule II on Page 68 of this Report.

(a)(3) Exhibits. The following exhibits are to be filed as part of the annual report:

| EXHIBIT NO. | IDENTIFICATION OF EXHIBIT |
|---|---|
| Exhibit 3.1 | Certificate of Incorporation, incorporated by reference to Exhibit B to the Definitive Information Statement filed October 21, 2003. |
| Exhibit 3.2 | Bylaws, incorporated by reference to Exhibit C to the Definitive Information Statement filed October 21, 2003. |
| +Exhibit 10.1 | 1995 Non-Qualified Stock Option Plan for Consultants and Non-Employee Directors, incorporated by reference to Exhibit 10.4 to the Company s Annual Report on Form 10-K for the fiscal year 1996. |
| +Exhibit 10.2 | The Company s Year 2000 Stock Incentive Plan adopted on August 29, 2000, and incorporated by reference as Appendix B from the Company s Definitive Proxy Statement on Schedule 14A filed August 9, 2000. |
| Exhibit 10.3 | Credit and Security Agreement dated May 27, 2005, between the Company and Merrill Lynch Business Financial Services, Inc., as a lender and as administrative agent for the lender parties thereto, incorporated by reference to Exhibit 10.1 to the Form 8-K filed June 1, 2005. |
| Exhibit 10.4 | Shanghai Assignment Agreement for Use Right of State-owned Land dated May 16, 2005, between Shanghai Jia Ding District Housing and Land Administrative Bureau and Shanghai DeAn Hospital (English translation), incorporated by reference to Exhibit 10.3 to the Form 10-Q for the fiscal quarter ended May 31, 2005. |
| Exhibit 10.5 | Shanghai Land Confiscation & Relocation Compensation Agreement dated May 16, 2005, between Shanghai Jia Ding District Housing and Land Administration Bureau and Shanghai DeAn Hospital (English translation), incorporated by reference to Exhibit 10.4 to the Form 10-Q for the fiscal quarter ended May 31, 2005. |
| Exhibit 10.6 | Stock Purchase and Subscription Agreement between the Company and the subscribers thereto, incorporated by reference to Exhibit 10.1 to the Form 10-Q for the fiscal quarter ended May 31, 2006. |
| Exhibit 10.7 | Form of Indemnification Agreement with various officers and directors of the Company, incorporated by reference to Exhibit 10.11 to the Form 10-K for the fiscal year ended August 31, 2004. |
| Exhibit 14.1 | Code of Ethics for Principal Executive and Senior Financial Officers, incorporated by reference to Exhibit 14.1 to the Company s Annual Report on Form 10-K for the fiscal year ended August 31, 2003. |
| Exhibit 21.1 | Listing of subsidiaries, incorporated by reference to Exhibit 21.1 to the Form 10-K for the fiscal year ended August 31, 2005. |
| Exhibit 23.1 | Consent of Killman, Murrell and Company, P.C. |
| 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. |

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| EXHIBIT NO. | IDENTIFICATION OF EXHIBIT |
|---|---|
| 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. |

+ Management contract or compensatory plan or arrangement.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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: November 21, 2006

By: /s/ Chiu M. Chan
Chiu M. Chan, Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ Chiu M. Chan<br>**Chiu M. Chan**<br>**(Principal Executive Officer)** | Chairman of the Board, CEO and President | November 21, 2006 |
| /s/ Philip S. Chan<br>**Philip S. Chan**<br>**(Principal Financial and Accounting Officer)** | Director, Vice President -Finance, CFO, and Treasurer | November 21, 2006 |
| /s/ Stephen L. Huber<br>**Stephen L. Huber** | Director | November 21, 2006 |
| /s/ Ping S. Chu<br>**Ping S. Chu** | Director | November 21, 2006 |
| /s/ James G. Gerace<br>**James G. Gerace** | Director | November 21, 2006 |

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## EXHIBIT INDEX

| EXHIBIT NO. | IDENTIFICATION OF EXHIBIT |
|---|---|
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| Exhibit 10.3 | Credit and Security Agreement dated May 27, 2005, between the Company and Merrill Lynch Business Financial Services, Inc., as a lender and as administrative agent for the lender parties thereto, incorporated by reference to Exhibit 10.1 to the Form 8-K filed June 1, 2005. |
| Exhibit 10.4 | Shanghai Assignment Agreement for Use Right of State-owned Land dated May 16, 2005, between Shanghai Jia Ding District Housing and Land Administrative Bureau and Shanghai DeAn Hospital (English translation), incorporated by reference to Exhibit 10.3 to the Form 10-Q for the fiscal quarter ended May 31, 2005. |
| Exhibit 10.5 | Shanghai Land Confiscation & Relocation Compensation Agreement dated May 16, 2005, between Shanghai Jia Ding District Housing and Land Administration Bureau and Shanghai DeAn Hospital (English translation), incorporated by reference to Exhibit 10.4 to the Form 10-Q for the fiscal quarter ended May 31, 2005. |
| Exhibit 10.6 | Stock Purchase and Subscription Agreement between the Company and the subscribers thereto, incorporated by reference to Exhibit 10.1 to the Form 10-Q for the fiscal quarter ended May 31, 2006. |
| Exhibit 10.7 | Form of Indemnification Agreement with various officers and directors of the Company, incorporated by reference to Exhibit 10.11 to the Form 10-K for the fiscal year ended August 31, 2004. |
| Exhibit 14.1 | Code of Ethics for Principal Executive and Senior Financial Officers, incorporated by reference to Exhibit 14.1 to the Company s Annual Report on Form 10-K for the fiscal year ended August 31, 2003. |
| Exhibit 21.1 | Listing of subsidiaries, incorporated by reference to Exhibit 21.1 to the Form 10-K for the fiscal year ended August 31, 2005. |
| Exhibit 23.1 | Consent of Killman, Murrell and Company, P.C. |
| 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. |

+ Management contract or compensatory plan or arrangement.