

DYNACQ HEALTHCARE INC
Form 10-Q
January 10, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 30, 2007

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

For the transition period from _____ to _____

Commission File Number: 000-21574

DYNACQ HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

76-0375477
(I.R.S. Employer
Identification No.)

10304 Interstate 10 East, Suite 369
Houston, Texas
(Address of principal executive offices)

77029
(Zip Code)

(713) 378-2000

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(Registrant's telephone number, including area code)

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

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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

As of January 7, 2008, the number of shares outstanding of the registrant's common stock, par value \$.001 per share, was 15,898,057.

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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 reviewed the accompanying consolidated balance sheet of Dynacq Healthcare, Inc., as of November 30, 2007, and the related consolidated statements of operations and cash flows for the three-month periods ended November 30, 2007 and 2006. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with United States of America generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Dynacq Healthcare, Inc., as of August 31, 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended not presented herein, and in our report dated November 6, 2007, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of August 31, 2007, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

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

Killman, Murrell & Company, P.C.

Houston, Texas

January 7, 2008

Table of Contents**PART I FINANCIAL INFORMATION****ITEM I FINANCIAL STATEMENTS****Dynacq Healthcare, Inc.****Consolidated Balance Sheets**

	November 30, 2007 (Reviewed)	August 31, 2007 (Audited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 7,321,137	\$ 5,436,787
Restricted cash	4,388,857	4,388,857
Current portion of accounts receivable, net of contractual allowances of approximately \$89,332,000 and \$68,187,000 at November 30, 2007 and August 31, 2007, respectively	13,827,745	10,526,365
Accounts receivable - other	11,771	17,704
Inventories	2,340,050	2,187,486
Prepaid expenses	318,291	430,391
Deferred tax assets	1,007,432	1,057,931
Income taxes receivable	1,493,069	1,519,138
Total current assets	30,708,352	25,564,659
Assets held for sale	11,453,023	13,187,738
Property and equipment, net	19,620,419	19,956,711
Long-term portion of accounts receivable, net of contractual allowances of approximately \$117,184,000 and \$128,981,000 at November 30, 2007 and August 31, 2007, respectively	18,138,899	19,911,300
Other assets	247,452	274,553
Total assets	\$ 80,168,145	\$ 78,894,961

See accompanying notes.

Table of Contents**Dynacq Healthcare, Inc.****Consolidated Balance Sheets (continued)**

	November 30, 2007 (Reviewed)	August 31, 2007 (Audited)
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 3,697,486	\$ 4,135,364
Accrued liabilities	5,730,246	5,653,672
Notes payable	5,305,964	7,526,181
Current portion of capital lease obligation	9,835	9,644
Current taxes payable	1,175,091	534,425
Total current liabilities	15,918,622	17,859,286
Non-current liabilities:		
Long-term portion of note payable	614,014	731,401
Long-term portion of capital lease obligation	15,480	18,012
Deferred tax liabilities	858,282	426,327
Total liabilities	17,406,398	19,035,026
Minority interests	571,853	599,015
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, 15,898,057 and 15,843,557 shares issued at November 30, 2007 and August 31, 2007, respectively	15,898	15,844
Additional paid-in capital	14,267,337	13,829,616
Accumulated other comprehensive income	276,889	219,520
Retained earnings	47,629,770	45,195,940
Total stockholders' equity	62,189,894	59,260,920
Total liabilities and stockholders' equity	\$ 80,168,145	\$ 78,894,961

See accompanying notes.

Table of Contents**Dynacq Healthcare, Inc.****Consolidated Statements of Operations**

(Reviewed)

	Three months ended November 30,	
	2007	2006
Net patient service revenue	\$ 13,842,318	\$ 9,971,245
Costs and expenses:		
Compensation and benefits	3,356,310	2,804,056
Medical services and supplies	2,716,391	2,228,875
Other operating expenses	3,701,409	4,885,022
Depreciation and amortization	536,795	653,529
Total costs and expenses	10,310,905	10,571,482
Operating income (loss)	3,531,413	(600,237)
Other income (expense):		
Rent and other income	126,394	31,775
Interest income	7,064	14,396
Interest expense	(72,194)	(120,696)
Total other income (expense), net	61,264	(74,525)
Income (loss) before income taxes, minority interests and extraordinary gain	3,592,677	(674,762)
Minority interest in earnings	(35,363)	(19,894)
Income (loss) before income taxes	3,557,314	(694,656)
Provision for income taxes	(1,377,428)	
Income (loss) from continuing operations	2,179,886	(694,656)
Income (loss) from discontinued operations, net of income taxes	253,944	(308,460)
Extraordinary gain, net of \$-0- income tax expense		45,244
Net income (loss)	\$ 2,433,830	\$ (957,872)
Basic earnings (loss) per common share:		
Income (loss) from continuing operations	\$ 0.14	\$ (0.04)
Income (loss) from discontinued operations, net of income taxes	0.01	(0.02)
Extraordinary gain, net of income tax expense		
Net income (loss)	\$ 0.15	\$ (0.06)
Diluted earnings (loss) per common share:		
Income (loss) from continuing operations	\$ 0.13	\$ (0.04)
Income (loss) from discontinued operations, net of income taxes	0.01	(0.02)
Extraordinary gain, net of income tax expense		

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Net income (loss)	\$ 0.14	\$ (0.06)
Basic average common shares outstanding	15,871,807	15,740,711
Diluted average common shares outstanding	16,674,017	15,740,711

See accompanying notes.

Table of Contents**Dynacq Healthcare, Inc.****Consolidated Statements of Cash Flows**

(Reviewed)

	Three months ended November 30,	
	2007	2006
Cash flows from operating activities		
Net income (loss)	\$ 2,433,830	\$ (957,872)
Less (income) loss from discontinued operations, net of income taxes	(253,944)	308,460
Net income (loss) before discontinued operations	2,179,886	(649,412)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Extraordinary gain, net of tax		(45,244)
Depreciation and amortization	536,795	653,529
Gain on sale of assets	(28,455)	
Deferred income taxes	447,404	
Minority interests	35,363	19,894
Charge for stock options to employees	124,425	
Income tax benefit for employees' exercise of incentive stock options	46,300	
Changes in operating assets and liabilities:		
Restricted cash		469,000
Accounts receivable	(1,528,979)	174,977
Inventories	(152,564)	53,645
Prepaid expenses	112,100	135,498
Income taxes receivable	26,069	
Other assets	30,701	(3,930)
Accounts payable	(443,788)	(1,019,954)
Accrued liabilities	76,574	1,565,641
Income taxes payable	640,666	
Cash provided by continuing activities	2,102,497	1,353,644
Cash provided by (used in) discontinued activities	253,944	(294,389)
Net cash provided by operating activities	2,356,441	1,059,255
Cash flows from investing activities		
Purchase of property and equipment	(107,486)	(54,234)
Proceeds from sale of assets	1,788,317	
Purchase of accounts receivable - other		(312,449)
Collections on purchased accounts receivable - other		37,179
Cash provided by (used in) continuing activities	1,680,831	(329,504)
Cash used in discontinued activities	(23,414)	
Net cash provided by (used in) investing activities	1,657,417	(329,504)
Cash flows from financing activities		
Principal payments on notes payable	(2,337,604)	(1,136,005)
Purchase of minority interest	(62,525)	(119,000)
Payments on capital lease	(2,341)	
Proceeds from exercise of stock options	267,050	

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Cash used in continuing activities	(2,135,420)	(1,255,005)
Cash used in discontinued activities		(38,508)
Net cash used in financing activities	(2,135,420)	(1,293,513)
Effect of exchange rate changes on cash	5,912	9,477
Net increase (decrease) in cash and cash equivalents	1,884,350	(554,285)
Cash at beginning of period	5,436,787	3,382,332
Cash at end of period	\$ 7,321,137	\$ 2,828,047

Continued.

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Supplemental cash flow disclosures

Cash paid during the period for:

Interest	\$ 117,999	\$ 128,764
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Income taxes	\$ 400,000	\$
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Non cash investing and financing activities:

Land cost from foreign currency gains	\$ (83,656)	\$ (57,789)
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Foreign currency gains	83,656	57,789
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See accompanying notes.

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Dynacq Healthcare, Inc.

Notes to Consolidated Financial Statements

November 30, 2007

(reviewed)

Basis of Presentation

The accompanying reviewed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal and recurring nature. The majority of the Company's expenses are cost of revenue items. Costs that could be classified as general and administrative by the Company would include the corporate office costs, including advertising and marketing expenses, which were approximately \$1.5 million and \$2.9 million for the quarters ended November 30, 2007 and 2006, respectively. These reviewed financial statements should be read in conjunction with the audited financial statements at August 31, 2007. Operating results for the quarter ended November 30, 2007 are not necessarily indicative of the results that may be expected for the year ending August 31, 2008.

The Company is a holding company and through its subsidiaries and its affiliates operates in one line of business. Its strategy is to develop and operate general acute care hospitals that provide principally specialized 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. Accordingly, the Company aggregates its hospitals into a single reportable segment as that term is defined by Statement of Financial Accounting Standards (SFAS) No. 131 Disclosures About Segments of an Enterprise and Related Information.

General

As of November 30, 2007, the Company operated one facility each in the Houston metropolitan area (Pasadena Facility), Dallas-Fort Worth area (Garland Facility) and in Baton Rouge (Baton Rouge Facility). Dynacq also owns a 70% equity interest in a joint venture formed under the laws of the Peoples Republic of China (the DeAn Joint Venture) to construct, own, and operate a hospital in Shanghai, China. The DeAn Joint Venture is currently negotiating a contract for the construction of the hospital, including obtaining governmental approval of the size and scope of services of the hospital.

Assets Held for Sale

During the quarter ended February 28, 2007, the Company sold its West Houston Facility. In May 2007, the Company signed an earnest money contract for sale of land in The Woodlands, Texas, and the sale was completed in September 2007. The Company entered into a Purchase and Sale Agreement (the Sale Agreement) for the sale of assets related to its Baton Rouge Facility on November 8, 2007, and the sale was subsequently completed in the second quarter of fiscal year 2008. The assets related to these facilities have been classified as Assets held for sale.

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 the preparation of these financial statements.

Table of Contents**Stock Based Compensation**

The Company's 2000 Incentive Plan (the "Plan") provides for options and other stock-based awards that may be granted to eligible employees, officers, consultants and non-employee directors of the Company or its subsidiaries. The Company had reserved 5,000,000 shares of common stock for future issuance under the Plan. As of November 30, 2007, there remain 1,896,508 shares which can be issued under the Plan, after giving effect to stock splits and shares issued under the Plan. All awards previously granted to employees under the Plan have been stock options, primarily intended to qualify as incentive stock options within the meaning of Section 422 of the Internal Revenue Code. The Plan also permits 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 Plan 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 Plan is 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 Plan. 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 Plan is necessary only when required by applicable law or stock exchange rules.

For the quarter ended November 30, 2007, there were no equity-based compensation awards granted. Generally, options granted become exercisable in annual installments of 25 percent beginning on the first anniversary date, and expire after five to ten years. The following table summarizes the stock option activities for the quarter ended November 30, 2007 (share amounts in thousands):

	Shares	Weighted Average Option Exercise Price Per Share	Weighted Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value ⁽¹⁾
Outstanding, August 31, 2007	2,151	\$ 3.77		\$ 6,053,359
Granted				
Exercised	(55)	4.90		63,585
Expired or canceled	(89)	2.74		
Outstanding, November 30, 2007	2,007	\$ 3.78		\$ 1,871,425

⁽¹⁾ These amounts represent the difference between the exercise price and \$4.05, the closing price of Dynacq common stock on November 30, 2007 as reported on the NASDAQ stock market, for all in-the-money options outstanding. For exercised options, intrinsic value represents the difference between the exercise price and the closing price of Dynacq common stock on the date of exercise.

For the quarter ended November 30, 2007 and 2006, the Company received \$267,050 and \$-0-, respectively, for stock options exercised. Total tax benefit realized for the tax deductions from stock options exercised was \$46,300 and \$-0- for the quarter ended November 30, 2007 and 2006, respectively.

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The following summarizes information related to stock options outstanding at November 30, 2007, and related weighted average price and life information:

Range of Exercise Prices		Options Outstanding			Options Exercisable	
		Shares	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
			(Share Amounts In Thousands)			
\$ 2.50	2.75	1,223	5.6	\$ 2.52		\$
\$ 4.44	5.00	683	5.8	4.78	683	4.78
\$12.25		101	0.5	12.25	101	12.25
Total		2,007	5.4	\$ 3.78	784	\$ 5.75

Additional information relating to the Plan at November 30, 2007 and August 31, 2007 is as follows (in thousands):

	November 30, 2007	August 31, 2007
Options exercisable	784	847
Options available for grant and reserved common stock shares for stock option plans	1,897	1,808

For the quarter ended November 30, 2007 and 2006, stock-based compensation expense associated with the Company's stock options was \$124,425 and \$-0-, respectively. The total unrecognized compensation expense for outstanding stock options as of November 30, 2007 was \$1.7 million, and will be recognized, in general, over 3.5 years. The weighted average number of years to recognize the compensation expense is 1.8 years.

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

Through the fiscal year ended August 31, 2005, the Company did not participate in managed care contracts. In the quarter ended November 30, 2005, the Company began such participation and currently participates in a small number of managed care contracts. 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 as a change in estimate during the current period. The Company does adjust current period revenue for actual differences in estimated revenue recorded in prior periods and actual cash collections. As the Company is able to identify specific closed blocks of business, the Company compares the actual cash collections on gross billed charges to the estimated collections that were recorded in revenue. The Company records additional revenue or a reduction in revenue in the current period equal to the difference in the estimate recorded and the actual cash collected.

The Company has recorded additional revenue of \$682,000 during the quarter ended November 30, 2007 related to amounts collected on accounts receivable with dates of service prior to May 1, 2002. These amounts were fully reserved for.

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The Company has recorded additional revenue on two specific blocks of business during the fiscal year ended August 31, 2006 as follows:

1. The Company collected \$4,928,992 on a block of business generated at our Garland Facility (which was acquired in August 2003) between September 2003 and December 2004. Gross billings on this block of receivables were \$8,482,598. The contractual allowance booked on this block of receivables was \$5,986,285, or approximately 70.5%, generating net revenue of \$2,496,313. Since the Company actually collected \$4,928,992 on this block of receivables, additional revenue in the amount of \$2,400,000 was recorded in the second quarter of fiscal year 2006.
2. The Company collected \$3,572,519 on a block of business generated at our Garland Facility between January 2005 and February 2006. Gross billings on this block of receivables were \$6,604,840. The contractual allowance booked on this block of receivables was \$4,531,716, or approximately 68.6%, generating net revenue of \$2,073,123. Since the Company actually collected \$3,572,519 on this block of receivables, additional revenues in the amounts of \$1,000,000 and \$500,000 were recorded in the first and second quarters of fiscal year 2006, respectively.

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 the three months ended November 30, 2007 and 2006:

	2007	2006
Gross billed charges	\$ 30,031,187	\$ 25,955,341
Contractual allowance	16,188,869	15,984,096
Net revenue	\$ 13,842,318	\$ 9,971,245
Contractual allowance percentage	54%	62%

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 accounts receivable in the Medical Dispute Resolution (MDR) process and legal third-party financial class (LTP). The contractual allowance is provided as revenue is recognized. At each balance sheet date management reviews the accounts receivable for collectibility. For each operating facility, the historical cash collection percentage (based on cash collections for the last twelve months) of each financial class, except MDR and LTP, is calculated by each aging bucket. These aging bucket specific percentages are then applied to the accounts receivable at each balance sheet date for each aging bucket and financial class to estimate the amount of accounts receivable management expects to collect. All accounts receivable over five months from date of service, except for MDR and LTP, are valued at zero in this balance sheet analysis. Accounts receivable related to MDR and LTP are estimated at 28% collectibility in our balance sheet analysis irrespective of the age of the accounts receivable. The Company initially receives an average 30 to 35% of gross billed charges either upon filing the insurance claim, or after filing a request for reconsideration to the insurance company. The Company applies these payments received to the gross accounts receivable, but does not adjust the balance on the account. The Company expects to collect on an average an additional 28% of the remaining MDR balance. The MDR accounts receivable are written off only after all collection efforts have failed, including the appeals process of MDR which may take several years. If after the review management believes certain receivables are uncollectible, the receivables are written down to the expected collectible amount. However, if the estimated amount to be collected is greater than the net accounts receivable as of the balance sheet date, no adjustment is made to accounts receivable (i.e. no additional revenue is booked), due to the length of time it takes to ultimately settle the MDR accounts receivable and the current uncertainty associated with such settlements.

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.

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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 has recently been successful in its pursuit of collections regarding the stop-loss cases pending before SOAH receiving positive rulings in over 90% of its claims presented for administrative determination. Further, in a declaratory judgment action before the 353rd State Judicial District Court of Travis County, Texas, the interpretation of the statute as applied to the stop-loss claims of the Company by SOAH was upheld. It is expected that the ruling of the trial court will be appealed to the State of Texas Third Court of Appeals by the insurance carriers. Claims regarding payment for hospital outpatient services remain pending at the TDWC. It is expected that these claims will be adjudicated at SOAH and ultimately in the Texas District and Appellate Courts.

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. It is very difficult for management to quantify with accuracy any reasonably likely effects that a change in estimate could have on the Company's financial position and results of operations. However, management believes that the most reasonably likely effects that a change in estimate could have on the Company's financial position and results of operations would be for the Company to collect amounts on accounts receivable greater than what is recorded on the books at November 30, 2007. The amount of such additional collections could range from zero to an amount that could approach \$75 million, which represents the ultimate amount that the Company could collect on its MDR accounts receivable as of November 30, 2007 if all were settled in the Company's favor. In accordance with the Company's revenue recognition policy, accounts receivable are not written up to amounts ultimately expected to be collected until management can demonstrate that collections on an identifiable group of accounts are more than the revenue which was recorded on the identified group of accounts. Amounts are not written up to management's estimated amounts due to the length of time it takes to ultimately settle the MDR accounts receivable and the current uncertainty associated with such settlements. Any change in this estimate would impact revenues in the statement of operations and cash in the statement of financial position.

Allowance for Uncollectible Accounts

The Company evaluates bad debt expenses periodically and, if needed, sets up an allowance for uncollectible accounts. Theoretically the only bad debts the Company could have are emergency room treatments which are not

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ultimately paid. These bad debt expenses are written off against the contractual allowance in order to streamline and standardize the charge off procedure. Pursuant to its analysis of bad debt expense, management determined that it no longer needed a separate provision for bad debts and terminated that separate provision effective March 1, 2007. Through the end of the quarter ended February 28, 2007, the Company had estimated uncollectible accounts expense of 1% of gross outpatient revenue. These bad debt expenses (provision for uncollectible accounts) through February 28, 2007 have been combined with other operating expenses in the Consolidated Statements of Operations, and the allowance for uncollectible accounts as of February 28, 2007 has been combined with the contractual allowance on the Consolidated Balance Sheet.

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 the investments were made. The Company also made the decision to sell its land in The Woodlands, Texas, since it no longer intended to build on that site. During the second quarter of fiscal year 2007, the Company sold its West Houston Facility. In May 2007, the Company signed an earnest money contract for sale of the land in The Woodlands, Texas, and the sale was subsequently completed in September 2007. The Company entered into the Sale Agreement for the sale of assets related to its Baton Rouge Facility on November 8, 2007, and the sale was completed in the second quarter of fiscal year 2008.

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 the three months ended November 30, 2007 and 2006 is as follows:

	2007	2006
Net patient service revenue	\$ 3,576,591	\$ 2,522,319
Costs and expenses	(3,166,721)	(2,864,016)
Other income	1,898	33,237
Income (loss) before income taxes	411,768	(308,460)
Provision for income taxes	(157,824)	
Income (loss) from discontinued operations, net of income taxes	\$ 253,944	\$ (308,460)

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 1% to 7% at November 30, 2007).

Comprehensive Income (Loss)

Comprehensive income (loss) for the three months ended November 30, 2007 and 2006 is as follows:

	2007	2006
Net income (loss)	\$ 2,433,830	\$ (957,872)
Foreign currency translation adjustment, net of taxes of \$35,050 and \$-0-, respectively	57,369	67,266
Comprehensive income (loss)	\$ 2,491,199	\$ (890,606)

Contingencies

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The Company maintains various insurance policies that cover each of its facilities. Specifically, the Company has occurrence coverage for its Pasadena and Garland Facilities. In Louisiana, the Company is a member of the

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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 workers' compensation coverage in Texas. In regard to the Employee Health Insurance Plan, the Company is self-insured with specific and aggregate re-insurance with stop-loss levels appropriate for the Company's group size. Coverage is maintained in amounts management deems adequate.

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 Revenue Recognition Accounts Receivable, as well as Business Government Regulation Texas and Louisiana Workers' Compensation Systems and Management's Discussion and Analysis of Financial Condition and Results of Operations Revenue Recognition Accounts Receivable in our Form 10-K for the fiscal year ended August 31, 2007, 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.

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

This quarterly report on Form 10-Q contains forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipates, believes, estimates, predicts, potential, or the need for, or other comparable terminology. These statements are only predictions. Actual events or results may differ materially. Such forward-looking statements relate to future events or future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our Company's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements, including the risks and uncertainties described in

Risk Factors in our annual report on Form 10-K for the fiscal year ended August 31, 2007. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. You must read the following discussion of the results of our business and our operations and financial condition in conjunction with our reviewed consolidated financial statements, including the notes, included in this quarterly report on Form 10-Q and our audited consolidated financial statements, including the notes, included in our Annual Report on Form 10-K for the fiscal year ended August 31, 2007.

Executive Summary

Update on Spinoff

On August 10, 2007, Dynacq's Board of Directors determined that it would be in the best interests of the shareholders to separate the domestic operations of the Company from its investment in the DeAn Joint Venture to design, construct, own and operate the China Project by a spinoff of the domestic operations into a separate company to be owned by Dynacq shareholders (the Spinoff). At the present time, management believes the Spinoff should be accomplished only after some additional progress has been made on the China Project, hence the Spinoff is being delayed.

The DeAn Joint Venture is continuing to negotiate a contract for the construction of the hospital in Shanghai, including obtaining governmental approval of the size and scope of services of the hospital. The Company is also negotiating for the sale of the government's interest in the DeAn Joint Venture to a third party. In addition, Dynacq may explore opportunities to operate and own majority controlling interests in other hospitals throughout China. The acquisition or construction of hospitals outside Shanghai will require the Company to apply for hospital licenses from both the central and local governments, an application process in which the Company has experience.

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Update on Assets Held for Sale

In 2006, the Company made the decision to sell the assets related to its Baton Rouge and West Houston Facilities and its land in The Woodlands, Texas. During the fiscal year ended August 31, 2007, the Company sold its West Houston Facility. In May 2007, the Company signed an earnest money contract for sale of the land in The Woodlands, Texas, and the sale was completed in September 2007. The net proceeds and gain on sale of land in The Woodlands, Texas were \$1.8 million and \$28,000, respectively. The Company entered into the Sale Agreement for the sale of assets related to its Baton Rouge Facility on November 8, 2007, and the sale was completed in the second quarter of fiscal year 2008. The net proceeds and gain on sale of the assets related to the Baton Rouge Facility were \$16.5 million and \$3.6 million, respectively. The assets related to these facilities have been classified as Assets held for sale .

Net Patient Service Revenues

Net patient service revenues increased \$3,871,073, or 39%, from the first fiscal quarter of 2007, primarily as a result of increase in the number of inpatient cases. Overall, there were 30, or 4%, more cases performed in the current fiscal quarter than in the same quarter of the prior year. An increase of 106 bariatric cases, or 207%, over the same quarter of the prior year resulted in the increase in net patient service revenue.

Costs and Expenses

Costs and expenses decreased \$260,577, or 2%, primarily due to a decline in other operating expenses, being partially offset by increased compensation and benefits and medical services and supplies expenses due to an increase in the number of cases.

Accounts Receivable

Our accounts receivable are larger and older than those of typical healthcare companies because of our pursuit of additional reimbursements through the MDR process. Please see Accounts Receivable in our Notes to Consolidated Financial Statements, as well as Accounts Receivable in our Form 10-K for the fiscal year ended August 31, 2007 for a more complete discussion. The delays caused by the unexpected and extended reimbursement process have increased our collection costs, including legal fees and expenses associated with collection and reimbursement activities.

Update on Critical Accounting Policies and Estimates

There have been no changes to the critical accounting policies used in our reporting of results of operations and financial position for the quarter ended November 30, 2007. For a discussion of our critical accounting policies see Management's Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the fiscal year ended August 31, 2007.

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	2007	Three months ended November 30, Percentage	2006	Percentage
Net patient service revenue	\$ 13,842,318	100%	\$ 9,971,245	100%
Costs and expenses:				
Compensation and benefits	3,356,310	24	2,804,056	28
Medical services and supplies	2,716,391	20	2,228,875	22
Other operating expenses	3,701,409	27	4,885,022	49
Depreciation and amortization	536,795	4	653,529	7
Total costs and expenses	10,310,905	74	10,571,482	106
Operating income (loss)	3,531,413	26	(600,237)	(6)
Other income (expense), net	61,264		(74,525)	(1)
Minority interest in earnings	(35,363)		(19,894)	
Income (loss) before income taxes	3,557,314	26	(694,656)	(7)
Provision for income taxes	(1,377,428)	(10)		
Income (loss) from continuing operations	2,179,886	16	(694,656)	(7)
Income (loss) from discontinued operations, net of income taxes	253,944	2	(308,460)	(3)
Extraordinary gain, net of \$-0- income tax expense			45,244	
Net income (loss)	\$ 2,433,830	18%	\$ (957,872)	(10)%

Operational statistics (Number of medical procedures) :

Inpatient:		
Bariatrics	157	51
Orthopedics	66	111
Other	35	8
Total inpatient procedures	258	170
Outpatient:		
Orthopedics	102	113
Other	354	401
Total outpatient procedures	456	514
Total procedures	714	684

Three Months Ended November 30, 2007 Compared to the Three Months Ended November 30, 2006

Net patient service revenue increased by \$3,871,073, or 39%, from \$9,971,245 to \$13,842,318, and total surgical cases increased by 4% from 684 cases to 714 cases for the quarters ended November 30, 2006 and 2007, respectively. Following are the percentage changes in net patient service revenues and number of cases at the hospital facilities:

Facility	Percentage increase/(decrease) from 2006 to 2007 Net patient service revenue	Cases
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Pasadena	5%	(26)%
Garland	74	48
Overall	39	4

The Garland and the Pasadena Facilities had an increase in bariatric cases due to recruitment of additional physicians. The increase in net patient service revenue is primarily due to a 52% increase in the inpatient cases, which typically have a higher average reimbursement per case.

According to the Company's revenue recognition policy, the Company has recorded additional revenue of \$682,000 during the quarter ended November 30, 2007 related to amounts collected on accounts receivable with dates of service prior to May 1, 2002. These amounts were fully reserved for.

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During the fiscal year ended August 31, 2006, the Company recorded additional revenue on two specific blocks of business as follows:

1. The Company collected \$4,928,992 on a block of business generated at our Garland Facility (which was acquired in August 2003) between September 2003 and December 2004. Gross billings on this block of receivables were \$8,482,598. The contractual allowance booked on this block of receivables was \$5,986,285, or approximately 70.5%, generating net revenue of \$2,496,313. Since the Company actually collected \$4,928,992 on this block of receivables, additional revenue in the amount of \$2,400,000 was recorded in the second quarter of fiscal year 2006.
2. The Company collected \$3,572,519 on a block of business generated at our Garland Facility between January 2005 and February 2006. Gross billings on this block of receivables were \$6,604,840. The contractual allowance booked on this block of receivables was \$4,531,716, or approximately 68.6%, generating net revenue of \$2,073,123. Since the Company actually collected \$3,572,519 on this block of receivables, additional revenues in the amounts of \$1,000,000 and \$500,000 were recorded in the first and second quarters of fiscal year 2006, respectively.

Excluding the above-mentioned additional revenues, net patient service revenue per case increased \$5,316, or 41%, from \$13,116 in 2006 to \$18,432 in 2007, and the number of cases increased by 4%.

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, the Company's contractual allowance as a percentage of gross patient revenue decreased from 62% in 2006 to 54% in 2007.

Total costs and expenses decreased by \$260,577, or 2%, from \$10,571,482 in 2006 to \$10,310,905 in 2007. The following discusses the various changes in costs and expenses:

Compensation and benefits increased by \$552,254, or 20%. During the quarter ended November 30, 2007, the Company incurred a \$124,425 non-cash pre-tax compensation expense related to employees' incentive stock options granted in fiscal year 2007. Excluding this non-cash compensation expense, the increase in compensation and benefits in the current fiscal quarter is 15% compared to the prior fiscal year, primarily due to an increase in number of cases.

Medical services and supplies expenses increased by \$487,516, or 22%, while the number of surgery cases increased 4%. The increase was due to a 52% increase in the number of inpatient procedures, which typically require more medical services and supplies.

Other operating expenses decreased by \$1,183,613, or 24%. Even though the net patient service revenue increased, the decrease in other operating expenses was due to the continued efforts made by the Company to reduce costs and expenses.

The income from discontinued operations represents the income at our Baton Rouge Facility and, for the quarter ended November 30, 2006, the West Houston Facility. The net patient service revenues at these facilities increased \$1,054,272, or 42%, from \$2,522,319 in 2006 to \$3,576,591 in 2007, and the total surgical cases also increased 18% from 352 cases in 2006 to 415 cases in 2007. Although the number of cases at our facilities increased 18%, the 42% increase in net patient service revenue per case was due to an increase of 86% in inpatient cases, primarily bariatric surgeries, at our Baton Rouge Facility. Total costs and expenses of the discontinued operations increased by \$302,705, or 11%, from \$2,864,016 in 2006 to \$3,166,721 in 2007, primarily due to an increase in the number of cases.

The extraordinary gain in 2006 of \$45,244, 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

Our 2007 Annual Report on Form 10-K includes a detailed discussion of our liquidity, contractual obligations and commitments. The information presented below updates and should be read in conjunction with the information disclosed in that Form 10-K.

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Cash flow from operating activities

Total cash flow provided by operating activities was \$2,356,441 (including \$253,944 provided by discontinued operations) during the period ended November 30, 2007, primarily due to a net income of \$2,433,830, increases in deferred income taxes and income taxes payable of \$1,088,070 and depreciation and amortization of \$536,795, partially offset by increases in accounts receivable of \$1,528,979 due to an increase in net patient service revenues, and decreases in accounts payable of \$443,788.

Cash flow from investing activities

Total cash flow provided by investing activities was \$1,657,417 (including \$23,414 used in discontinued operations) primarily related to the sale proceeds of the land in The Woodlands, Texas. Subsequent to the end of the quarter ended November 30, 2007, the Company completed the sale of the assets related to its Baton Rouge Facility, and received \$16.5 million in net proceeds.

Cash flow from financing activities

Total cash flow used in financing activities was \$2,135,420 during the current period. During the quarter ended November 30, 2007, the Company paid down \$2,227,037 under its Credit Agreement and also paid \$110,567 related to the note payable for class action lawsuit settlement. The Company received \$267,050 from the exercise of employees' stock options.

The Company had working capital of \$14,789,730 as of November 30, 2007, and maintained a liquid position by a current ratio of approximately 1.93 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 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 November 30, 2007, the Company had drawn \$4.8 million of approximately \$8.0 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 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 January 7, 2008, the Company had paid down the entire outstanding amount of \$4.8 million and had no amounts borrowed and had the maximum \$8.0 million available to borrow 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 mentioned above.

We believe we will be able to meet our ongoing liquidity and cash needs for fiscal year 2008 through the combination of available cash, cash flow from operations and borrowings under our Credit Agreement.

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS No. 141(R)) and SFAS No. 160, "Noncontrolling Interest in Consolidated Financial Statements" (SFAS No. 160). These new standards represent the outcome of the FASB's joint project with the International Accounting Standards Board and are intended to improve, simplify and converge internationally the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements.

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SFAS No. 141(R) replaces SFAS No. 141, Business Combinations, however, it retains the fundamental requirements of the former Statement that the acquisition method of accounting (previously referred to as the purchase method) be used for all business combinations and for an acquirer to be identified for each business. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. The new standard requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination.

SFAS No. 160 amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. This Statement changes the way the consolidated income statement is presented by requiring net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest and to disclose those amounts on the face of the income statement. It also aligns the reporting of noncontrolling interest in subsidiaries with the requirements in International Accounting Standard 27.

Both SFAS No. 141(R) and SFAS No. 160 are effective beginning in our fiscal 2010. SFAS No. 141 (R) will be applied to business combinations that are consummated beginning in fiscal 2010 and SFAS No. 160 will be applied prospectively to all noncontrolling interests, including any that arose before fiscal 2010. We are currently evaluating these Statements and have not yet determined their effect on our consolidated financial statements.

Item 3. 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 \$9 million to date to the DeAn Joint Venture, the majority of which are in local currency, all of the Company's contracts are denominated in U.S. 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 \$4.8 million as of November 30, 2007 from its five-year revolving credit facility. The balance owed under the facility as of January 7, 2008 was \$-0-. 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 receivable 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.

Item 4. 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.

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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 November 30, 2007. Based on that evaluation, we believe that, as of November 30, 2007, our internal control over financial reporting is effective.

Subsequent to the evaluation and through the date of this filing of Form 10-Q for the fiscal quarter ending November 30, 2007, 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.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

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 facilities' fees must be made in the district courts of Travis County, Texas in what can often be a lengthy procedure. Please refer to Revenue Recognition - Accounts Receivable, as well as Business Government Regulation - Texas and Louisiana Workers' Compensation Systems and Management's Discussion and Analysis of Financial Condition and Results of Operations - Revenue Recognition - Accounts Receivable in our Form 10-K for the fiscal year ended August 31, 2007, 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.

Item 1A. Risk Factors.

The Company's Risk Factors as disclosed in its Form 10-K for the year ended August 31, 2007 have not changed except that the following should be substituted for the fifth risk factor under "Risks Related to Our Business" on page 17 of that Form 10-K:

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

The Company was unable to make a contribution to the DeAn Joint Venture of approximately \$2.33 million by June 2, 2006 and approximately \$2.33 million by June 2, 2007, resulting in a technical default under the Joint Venture Agreement. That aggregate amount was paid by the Company to the DeAn Joint Venture on July 31, 2007. 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 aggregating \$3.3 million 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 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 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.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

EXHIBIT NO. IDENTIFICATION OF EXHIBIT

Exhibit 15.1 Awareness Letter of Killman, Murrell & Company, P.C.

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.

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SIGNATURES

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

DYNACQ HEALTHCARE, INC.

Date: January 10, 2008

By: /s/ Chiu M. Chan
Chiu M. Chan
Chief Executive Officer
(duly authorized officer)

Date: January 10, 2008

By: /s/ Philip S. Chan
Philip S. Chan
Chief Financial Officer
(principal financial and accounting officer)

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INDEX OF EXHIBITS

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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.