

DYNACQ HEALTHCARE INC  
Form 10-Q  
April 13, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended February 29, 2012

☐ **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)

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<b>Nevada</b> (State or other jurisdiction of incorporation or organization)	<b>76-0375477</b> ( I.R.S. Employer Identification No.)
<b>4301 Vista Road</b>  <b>Pasadena, Texas</b> (Address of principal executive offices)	<b>77504</b> (Zip Code)
<b>(713) 378-2000</b> (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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>

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 April 13, 2012, the number of shares outstanding of the registrant's common stock, par value \$.001 per share, was 14,543,626.

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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. (the Company), as of February 29, 2012, and the related consolidated statements of operations and cash flows for the three-month and six-month periods ended February 29, 2012 and February 28, 2011. 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, 2011, 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 16, 2011, 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, 2011, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KWCO, P.C.

KWCO, P.C.

Houston, Texas

April 13, 2012

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

	<b>February 29, 2012 (Reviewed)</b>	<b>August 31, 2011 (Audited)</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 15,842,467	\$ 24,315,160
Accounts receivable, net of contractual allowances of approximately \$187,059,000 and \$188,513,000 at February 29, 2012 and August 31, 2011, respectively	500,824	1,192,279
Inventories	474,109	550,441
Trading securities	1,424,399	1,471,644
Interest receivable	178,874	192,366
Prepaid expenses	198,121	272,414
Income tax receivable	2,363,724	2,363,724
Assets of discontinued operations	6,651,726	6,909,527
<b>Total current assets</b>	<b>27,634,244</b>	<b>37,267,555</b>
Investments available-for-sale	18,281,129	18,722,274
Investment in real estate, net	1,915,218	1,941,041
Property and equipment, net	7,038,699	7,168,864
Income tax receivable	868,249	868,249
Deferred tax asset	612,216	
Other assets	249,695	255,517
<b>Total assets</b>	<b>\$ 56,599,450</b>	<b>\$ 66,223,500</b>

*See accompanying notes.*

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

	<b>February 29, 2012 (Reviewed)</b>	<b>August 31, 2011 (Audited)</b>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 1,974,753	\$ 2,346,720
Accrued liabilities	13,691,664	18,430,553
Current portion of notes payable	121,543	97,918
Current portion of capital lease obligations	97,794	94,044
Liabilities of discontinued operations	615,598	604,302
Total current liabilities	16,501,352	21,573,537
Non-current liabilities:		
Long-term portion of notes payable	1,125,903	1,093,961
Long-term portion of capital lease obligations	139,308	189,161
Total liabilities	17,766,563	22,856,659
Commitments and contingencies		
Equity:		
Dynacq stockholders' equity:		
Preferred stock, \$.01 par value; 5,000,000 shares authorized, none issued or outstanding		
Common stock, \$.001 par value; 100,000,000 shares authorized, 14,543,626 and 14,426,960 shares issued at February 29, 2012 and August 31, 2011	14,544	14,427
Additional paid-in capital	10,047,320	9,780,837
Accumulated other comprehensive income	6,326,320	7,453,676
Retained earnings	22,314,605	26,054,284
Total Dynacq stockholders' equity	38,702,789	43,303,224
Non-controlling interest	130,098	63,617
Total equity	38,832,887	43,366,841
Total liabilities and equity	\$ 56,599,450	\$ 66,223,500

*See accompanying notes.*

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

(Reviewed)

	Three months ended		Six months ended	
	February 29, 2012	February 28, 2011	February 29, 2012	February 28, 2011
Net patient service revenue	\$ 966,716	\$ 1,688,813	\$ 2,811,689	\$ 4,138,628
Costs and expenses:				
Compensation and benefits	2,019,312	1,604,895	3,696,681	3,603,843
Medical services and supplies	343,508	365,464	566,626	784,020
Other operating expenses	1,349,336	1,550,251	2,672,125	3,354,188
Depreciation and amortization	160,287	44,109	310,098	90,954
Total costs and expenses	3,872,443	3,564,719	7,245,530	7,833,005
Operating loss	(2,905,727)	(1,875,906)	(4,433,841)	(3,694,377)
Other income (expense):				
Rent and other income	1,257,844	196,608	1,260,442	977,266
Interest income	338,305	353,763	606,203	740,453
Interest expense	(143,265)	(9,750)	(294,589)	(20,300)
Total other income, net	1,452,884	540,621	1,572,056	1,697,419
Loss before income taxes from continuing operations	(1,452,843)	(1,335,285)	(2,861,785)	(1,996,958)
Benefit for income taxes		493,030		666,679
Loss from continuing operations	(1,452,843)	(842,255)	(2,861,785)	(1,330,279)
Discontinued operations, net of income taxes	(169,547)	(715,258)	(732,213)	(1,384,909)
Loss on disposal of discontinued operations, net of income taxes	(229,201)	(121,577)	(229,201)	(121,577)
Net loss	(1,851,591)	(1,679,090)	(3,823,199)	(2,836,765)
Less: Net loss attributable to noncontrolling interest	56,005	1,728	83,520	2,763
Net loss attributable to Dynacq Healthcare, Inc.	\$ (1,795,586)	\$ (1,677,362)	\$ (3,739,679)	\$ (2,834,002)
Basic and diluted loss per common share:				
Loss from continuing operations attributable to Dynacq Healthcare, Inc.	\$ (0.10)	\$ (0.06)	\$ (0.19)	\$ (0.09)
Discontinued operations, net of income taxes	(0.01)	(0.05)	(0.05)	(0.10)
Loss on disposal of discontinued operations, net of income taxes	(0.02)	(0.01)	(0.02)	(0.01)
Net loss attributable to Dynacq Healthcare, Inc.	\$ (0.13)	\$ (0.12)	\$ (0.26)	\$ (0.20)
Basic and diluted average common shares outstanding	14,456,127	14,176,960	14,443,627	14,176,960
Amounts attributable to Dynacq Healthcare, Inc.:				
Loss from continuing operations	\$ (1,396,838)	\$ (840,527)	\$ (2,778,265)	\$ (1,327,516)
Discontinued operations, net of income taxes	(169,547)	(715,258)	(732,213)	(1,384,909)
Loss on disposal of discontinued operations, net of income taxes	(229,201)	(121,577)	(229,201)	(121,577)

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Net loss attributable to Dynacq Healthcare, Inc.	\$ (1,795,586)	\$ (1,677,362)	\$ (3,739,679)	\$ (2,834,002)
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*See accompanying notes.*



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

(Reviewed)

	Six months ended	
	February 29, 2012	February 28, 2011
<b>Cash flows from operating activities</b>		
Net loss	\$ (3,739,679)	\$ (2,834,002)
Less loss from discontinued operations, net of income taxes	961,414	1,506,486
Net loss before discontinued operations	(2,778,265)	(1,327,516)
Adjustments to reconcile net loss before discontinued operations to net cash used in operating activities:		
Depreciation and amortization	310,098	90,954
Loss on trading securities	57,101	14,995
Deferred income taxes	(1,655,662)	272,534
Noncontrolling interest	(83,520)	(2,763)
Charge for stock options to employees	149,934	4,251
Charge for non-controlling interest sale and issuance of stock awards	166,666	
Foreign currency exchange losses (gains)	152,435	(157,939)
Changes in operating assets and liabilities:		
Accounts receivable	691,455	1,112,382
Interest receivable	13,493	110,183
Inventories	76,332	55,313
Prepaid expenses	74,293	290,635
Income taxes receivable		(1,710,119)
Other assets	5,316	29,979
Accounts payable	(371,967)	291,070
Accrued liabilities	(4,766,187)	(802,185)
Cash used in continuing activities	(7,958,478)	(1,728,226)
Cash used in discontinued activities	(696,218)	(1,239,848)
Net cash used in operating activities	(8,654,696)	(2,968,074)
<b>Cash flows from investing activities</b>		
Purchase of trading securities		(4,909,498)
Sales proceeds of trading securities		3,494,738
Purchase of equipment	(157,753)	(6,794)
Cash used in continuing activities	(157,753)	(1,421,554)
Cash used in discontinued activities		(101,651)
Net cash used in investing activities	(157,753)	(1,523,205)
<b>Cash flows from financing activities</b>		
Proceeds from notes payable	116,339	65,000
Principal payments on notes payable	(60,773)	(44,567)
Payments on capital lease	(46,103)	(42,635)
Contributions from, and distributions to, noncontrolling interest, net	100,000	
Cash provided by (used in) continuing activities	109,463	(22,202)

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Cash used in discontinued activities		(23,222)
Net cash provided by (used in) financing activities	109,463	(45,424)
Effect of exchange rate changes on cash	230,293	484,536
Net decrease in cash and cash equivalents	(8,472,693)	(4,052,167)
Cash at beginning of period	24,315,160	27,665,945
Cash at end of period	\$ 15,842,467	\$ 23,613,778

Continued.

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

(Reviewed)

	Six months ended	
	February 29, 2012	February 28, 2011
<b>Supplemental cash flow disclosures</b>		
Cash paid during the period for:		
Interest	\$ 728,788	\$ 22,804
Income taxes	\$ 0	\$ 0
<b>Non cash investing and financing activities:</b>		
Investments available-for-sale	\$ (278,855)	\$ 1,024,427
Accumulated other comprehensive income	181,256	(665,877)
Deferred tax liabilities	97,599	(358,550)
Equipment from capital lease (discontinued operations)		34,592
Capital lease obligation (discontinued operations)		(34,592)

*See accompanying notes.*

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### **Dynacq Healthcare, Inc.**

### **Notes to Consolidated Financial Statements**

**February 29, 2012**

(reviewed)

#### **General**

Dynacq Healthcare, Inc., a Nevada corporation (the Company), is a holding company that through its subsidiaries in the United States develops and manages general acute care hospitals that principally provide specialized surgeries. The Company through its subsidiaries in China and Hong Kong also (1) provided healthcare management services to a hospital in China until February 28, 2011; and (2) invests in debt and equity securities, including short-term investments in initial public offerings and pre-initial public offerings. The Company through its United States subsidiaries (1) owns and operates one general acute care hospital in Pasadena, Texas, and (2) owns one general acute care hospital in Garland, Texas, which was closed on September 30, 2011, and accordingly this business is classified as Discontinued Operations for the six months ended February 29, 2012 and February 28, 2011 (see Note below on Discontinued Operations). The Company is currently composed of two divisions: U.S. and Corporate.

#### **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 \$1.3 million for the three months ended February 29, 2012 and February 28, 2011, respectively, and \$2.8 million and \$3.2 million for the six months ended February 29, 2012 and February 28, 2011, respectively. These reviewed financial statements should be read in conjunction with the audited financial statements at August 31, 2011. Operating results for the three and six months ended February 29, 2012 are not necessarily indicative of the results that may be expected for the year ending August 31, 2012.

#### **Reorganization of Segments and Reclassification**

The Industry Segment U.S. Division comprises of the Company's Pasadena facility. In the prior year it was classified as discontinued operations in the consolidated financial statements. The Company at the present time has the U.S. Division and the Corporate Division. Certain previously reported financial information has been reclassified to conform to the current year's presentation. The impact of such reclassification was not significant to the prior year's overall presentation, except for (1) presenting the Pasadena facility as continuing operations under U.S. Division, which was presented in the prior year as discontinued operations, and (2) the presentation of the various subsidiaries (except for Dynacq Huai Bei Healthcare, Inc. (Dynacq-Huai Bei) and Sino Bond Inc. Limited (Sino Bond), which are now shown as part of the Corporate Division) in China as discontinued operations under the Corporate Division, which in the previous year was shown as part of continuing operations under the China Division.

#### **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.

#### **Investments in Available-for-Sale and Trading Securities**

The Company has invested in various bonds. These investments are classified as available-for-sale securities, and are carried at fair value as of February 29, 2012, based on the quoted market prices as of that date. These investments are subject to default risk. The Company intends to hold these for a minimum period of an additional



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12 months. Unrealized gains in the fair value are reported in accumulated other comprehensive income, net of related income tax effect. The Company monitors its investment portfolio for any decline in fair value that is other than temporary and records any such impairment as an impairment loss.

The Company also invests in initial public offerings of equity securities on the Hong Kong Stock Exchange. These investments are classified as trading securities, and are carried at fair value as of February 29, 2012. These investments are subject to fluctuations in the market price. During the six months ended February 29, 2012 and February 28, 2011, the Company had a net loss of \$57,101 and \$14,995 in trading of these securities, respectively.

### **Investment in Real Estate and Notes Payable**

In March 2010, the Company purchased an apartment in Hong Kong as an investment for \$2,014,207. This apartment was used as a security to obtain an 18-year mortgage loan of \$1,245,775 from a financial institution, with a variable interest rate at the lower of 3-month Hang Seng Interbank Offered Rates plus 0.7% or 2.9% below the Hong Kong Dollar best lending rate quoted by the financial institution. The effective interest rate at February 29, 2012 was 1.1%. The Company has paid down \$32,090 and \$31,651 during the six months ended February 29, 2012 and February 28, 2011, respectively, and the current and long-term portions of the note payable as of February 29, 2012 are \$64,319 and \$1,059,320, respectively. Depreciation expense associated with the apartment was \$12,912 in each year for the three months ended February 29, 2012 and February 28, 2011, and \$25,824 in each year for the six months ended February 29, 2012 and February 28, 2011.

In November 2011 and September 2010, the Company borrowed \$116,339 and \$65,000 as notes payable from a financial institution at an interest rate of 4.5% and 6%, which notes are to be repaid in 36 and 24 monthly installments, respectively, and are secured by specific equipments purchased at our Pasadena facility. The Company has paid down \$28,683 during the six months ended February 29, 2012, and the current and long-term portions of the notes payable as of February 29, 2012 are \$57,224 and \$66,583, respectively.

### **Inventories**

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

### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The most significant of the Company's estimates is the determination of revenue to recognize for the services the Company provides and the determination of 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.

### **Discontinued Operations**

Under ASC Topic 360-10-35, Property, Plant, and Equipment - Subsequent Measurement (formerly referred to as SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*), we classify assets to be disposed of as held for sale or, if appropriate, discontinued operations when they have received appropriate approvals to be disposed of by our management or Board of Directors. Cash flows from our discontinued businesses are reflected as discontinued operating, investing, and financing activities in our statement of cash flows. We had \$6,651,726 of assets of discontinued operations and \$615,598 of liabilities of discontinued operations as of February 29, 2012.

### **U.S. Division**

The Company had made the decision to sell its Garland facility as of August 31, 2010, and its operation was classified as discontinued operations for the year ended August 31, 2010. However, the Company closed the Garland facility on September 30, 2011, and accordingly its operations for the fiscal years 2011 and 2012 continue to be classified as discontinued operations. The Company plans to either sell the Garland facility or pursue converting it into an ambulatory surgical center, if and when the Company can identify and generate a steady referral source for outpatient cases. The Company intended to sell its Pasadena facility also, and had it classified as discontinued operations, as of August 31, 2010. However, since a sale was not consummated during the 12-month



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period following the decision to sell, the operations of the Pasadena facility have been reclassified as continuing operations for the fiscal years 2011 and 2012. The Company is continuing to revamp its operations at the Pasadena facility by modifying the business model and controlling expenses. However, there can be no assurance that we will be successful in turning the facility around.

The Company had an independent appraisal done for both the hospitals in October 2011, and based on each hospital's valuation, expected sale proceeds, and expected cash flows has determined that there is no impairment charge required in connection with the foregoing disposal activities. Because we do not intend to sell the accounts receivable of hospitals in discontinued operations, the receivables are included in our accounts receivable in the accompanying Consolidated Balance Sheets.

## **Corporate Division**

The Company's operations at Second People's Hospital and its various proposed businesses in China, including but not limited to sandstone mining, mined coal trading, natural gas stations and sale of artifacts have been classified as discontinued operations. The Company's two foreign subsidiaries, Dynacq-Huai Bei and Sino Bond, are the only two companies that continue to be classified as continuing operations, and its other foreign subsidiaries have been reclassified as discontinued operations.

The following is a summary of financial information related to our discontinued operations for the three and six months ended February 29, 2012 and February 28, 2011. We have reclassified prior period financial statements to exclude these businesses from continuing operations.



**Table of Contents****Discontinued Operations**

	Three months ended February 29, 2012			Three months ended February 28, 2011		
	U.S. Division	Corporate Division	Total	U.S. Division	Corporate Division	Total
Net patient service revenue	\$ 93,711	\$	\$ 93,711	\$ 734,538	\$ 339,910	\$ 1,074,448
Costs and expenses:						
Compensation and benefits	11,196		11,196	657,684	285,781	943,465
Medical services and supplies	46,580		46,580	250,524	130,807	381,331
Other operating expenses	195,171		195,171	660,700	232,608	893,308
Depreciation and amortization					10,754	10,754
Total costs and expenses	252,947		252,947	1,568,908	659,950	2,228,858
Operating loss	(159,236)		(159,236)	(834,370)	(320,040)	(1,154,410)
Other income (expense), net	(10,311)		(10,311)	2,762	56,790	59,552
Loss before income taxes	(169,547)		(169,547)	(831,608)	(263,250)	(1,094,858)
Benefit for income taxes				267,827	111,773	379,600
Loss on discontinued operations, net of income taxes	(169,547)		(169,547)	(563,781)	(151,477)	(715,258)
Loss on disposal of discontinued assets		(229,201)	(229,201)		(187,041)	(187,041)
Benefit for income taxes					65,464	65,464
Loss on disposal of discontinued assets, net of income taxes		(229,201)	(229,201)		(121,577)	(121,577)
Total loss on discontinued operations, net of taxes	\$ (169,547)	\$ (229,201)	\$ (398,748)	\$ (563,781)	\$ (273,054)	\$ (836,835)

	Six months ended February 29, 2012			Six months ended February 28, 2011		
	U.S. Division	Corporate Division	Total	U.S. Division	Corporate Division	Total
Net patient service revenue	\$ 318,587	\$	\$ 318,587	\$ 1,288,049	\$ 831,232	\$ 2,119,281
Costs and expenses:						
Compensation and benefits	166,803	22,511	189,314	1,334,918	556,100	1,891,018
Medical services and supplies	267,551		267,551	476,252	406,452	882,704
Other operating expenses	533,115	98,493	631,608	1,282,304	358,232	1,640,536
Depreciation and amortization		5,175	5,175		21,180	21,180
Total costs and expenses	967,469	126,179	1,093,648	3,093,474	1,341,964	4,435,438
Operating loss	(648,882)	(126,179)	(775,061)	(1,805,425)	(510,732)	(2,316,157)
Other income (expense), net	(21,056)	63,904	42,848	2,813	191,474	194,287
Loss before income taxes	(669,938)	(62,275)	(732,213)	(1,802,612)	(319,258)	(2,121,870)
Benefit for income taxes				585,218	151,743	736,961

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Loss on discontinued operations, net of income taxes	(669,938)	(62,275)	(732,213)	(1,217,394)	(167,515)	(1,384,909)
Loss on disposal of discontinued assets		(229,201)	(229,201)		(187,041)	(187,041)
Benefit for income taxes					65,464	65,464
Loss on disposal of discontinued assets, net of income taxes		(229,201)	(229,201)		(121,577)	(121,577)
Total loss on discontinued operations, net of taxes	\$ (669,938)	\$ (291,476)	\$ (961,414)	\$ (1,217,394)	\$ (289,092)	\$ (1,506,486)

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	February 29, 2012			August 31, 2011		
	U.S. Division	Corporate Division	Total	U.S. Division	Corporate Division	Total
Current assets	\$	\$ 120,954	\$ 120,954	\$ 260,020	\$ 118,734	\$ 378,754
Property and equipment, net	6,530,772		6,530,772	6,530,773		6,530,773
Total assets	\$ 6,530,772	\$ 120,954	\$ 6,651,726	\$ 6,790,793	\$ 118,734	\$ 6,909,527
Current liabilities:						
Accounts payable and accrued liabilities	\$	\$ 615,598	\$ 615,598	\$	\$ 604,302	\$ 604,302
Total liabilities	\$	\$ 615,598	\$ 615,598	\$	\$ 604,302	\$ 604,302

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### Net Loss per Share

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

	Three months ended		Six months ended	
	February 29, 2012	February 28, 2011	February 29, 2012	February 28, 2011
Basic and diluted loss per common share:				
Numerator:				
Loss from continuing operations	\$ (1,452,843)	\$ (842,255)	\$ (2,861,785)	\$ (1,330,279)
Less: Net loss attributable to noncontrolling interest	56,005	1,728	83,520	2,763
Loss from continuing operations attributable to Dynacq Healthcare, Inc.	(1,396,838)	(840,527)	(2,778,265)	(1,327,516)
Discontinued operations, net of income taxes	(169,547)	(715,258)	(732,213)	(1,384,909)
Loss on disposal of discontinued operations, net of income taxes	(229,201)	(121,577)	(229,201)	(121,577)
Net loss attributable to Dynacq Healthcare, Inc.	\$ (1,795,586)	\$ (1,677,362)	\$ (3,739,679)	\$ (2,834,002)
Denominator:				
Basic and diluted average common shares outstanding	14,456,127	14,176,960	14,443,627	14,176,960
Basic and diluted loss per common share:				
Loss from continuing operations attributable to Dynacq Healthcare, Inc.	\$ (0.10)	\$ (0.06)	\$ (0.19)	\$ (0.09)
Discontinued operations, net of income taxes	(0.01)	(0.05)	(0.05)	(0.10)
Loss on disposal of discontinued operations, net of income taxes	(0.02)	(0.01)	(0.02)	(0.01)
Net loss attributable to Dynacq Healthcare, Inc.	\$ (0.13)	\$ (0.12)	\$ (0.26)	\$ (0.20)

Basic net income (loss) per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted net income (loss) per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted net income (loss) per share, the basic weighted average number of shares is increased by the dilutive effect of stock options determined using the treasury stock method. However, if it is anti-dilutive, the dilutive effect of the stock options is not included in the calculation of diluted net income (loss) per share. Stock options with exercise prices exceeding current market prices that were excluded from the computation of net income (loss) per share amounted to approximately 2,367,000 shares and 1,139,000 shares for the six months ended February 29, 2012 and February 28, 2011, respectively.

### Stock Based Compensation

#### Year 2011 Stock Incentive Plan

In August 2011, we mailed an Information Statement to all of our stockholders of record as of July 29, 2011. The Information Statement disclosed that our Board of Directors had approved, and the holders of a majority of the outstanding shares of our common stock had executed an Action by Written Consent of Stockholders in Lieu of a Special Meeting (the "Written Consent"), approving the adoption of the Year 2011 Stock Incentive Plan ("2011 Plan").

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

On November 14, 2011, the Compensation Committee granted stock options to purchase an aggregate of 200,000 shares under the 2011 Plan, with a weighted average exercise price of \$1.07 to two employees. These stock options will vest based on certain operating performance criteria, and expire after five years. The shares underlying these stock options are registered under the Securities Act of 1933 (the "Securities Act").

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

On February 6, 2012, the Compensation Committee granted stock options to purchase an aggregate of one million shares under the 2011 Plan, with a weighted average exercise price of \$1.00 to various employees. These stock options will vest based on certain operating performance criteria, and expire after five years. The shares underlying these stock options are registered under the Securities Act.

As of February 29, 2012, there remain 13,650,000 shares which can be issued under the 2011 Plan after giving effect to shares issued.

**2000 Incentive Plan**

The Company's 2000 Incentive Plan ("2000 Plan") provides for options and other stock-based awards that may be granted to eligible employees, officers, consultants and non-employee directors of the Company or its subsidiaries. The 2000 Plan does not have a fixed termination date, provided that no incentive stock option can be granted subsequent to August 29, 2011. As of February 29, 2012, there remain 2,023,066 shares to be issued upon exercise of outstanding options, and no new stock options awards will be issued under the 2000 Plan.

The 2011 Plan and the 2000 Plan (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 2011 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 Plans is necessary only when required by applicable law or stock exchange rules.

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 six months ended February 29, 2012 (share amounts in thousands):

	Shares	Weighted Average Option Exercise Price Per Share	Weighted Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value <sup>(1)</sup>
Outstanding, August 31, 2011	2,206	\$ 2.41	\$	\$
Granted	1,450	1.03	0.52	
Exercised				
Expired or canceled	(283)	1.79		
Outstanding, February 29, 2012	3,373	\$ 1.87	\$	\$



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(1) These amounts represent the difference between the exercise price and the closing price of Dynacq common stock on February 29, 2012 and August 31, 2011, 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 six months ended February 29, 2012 and February 28, 2011, there were no stock options exercised.

The following summarizes information related to stock options outstanding as of February 29, 2012, 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)				
\$ 1.00	1.10	1,350	6.0	\$ 1.03		\$
\$ 1.86	2.05	1,200	9.4	1.89		
\$ 2.50	2.75	587	1.3	2.54	587	2.54
\$ 4.90	4.96	236	2.6	4.90	236	4.90
Total		3,373	6.1	\$ 1.87	823	\$ 3.22

For the three months ended February 29, 2012 and February 28, 2011, stock-based compensation expense associated with the Company's stock options was \$82,244 and \$(102,963), respectively. For the six months ended February 29, 2012 and February 28, 2011, stock-based compensation expense associated with the Company's stock options was \$149,934 and \$4,251, respectively. The total unrecognized compensation expense for outstanding stock options as of February 29, 2012 was \$1,464,000, and will be recognized, in general, over 3.8 years. The weighted average time to recognize the compensation expense is 1.9 years.

**Fair Value of Financial Instruments**

On September 1, 2008, the Company adopted ASC Topic 825-10-25, Financial Instruments (formerly referred to as SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities (SFAS 159)), which permits entities to choose to measure certain financial assets and liabilities at fair value. The adoption of ASC Topic 825-10-25 had no impact on the consolidated financial statements because the Company did not elect the fair value option for any financial assets or financial liabilities that were not already recorded at fair value.

On September 1, 2008, the Company adopted ASC Topic 820, Fair Value Measurements and Disclosures (formerly referred to as SFAS 157) for our financial assets and liabilities. Management uses the fair value hierarchy of ASC Topic 820, which gives the highest priority to quoted prices in active markets. The fair value of financial instruments is estimated based on market trading information, where available. Absent published market values for an instrument or other assets, management uses observable market data to arrive at its estimates of fair value. Management believes that the carrying amount of cash and cash equivalents, accounts receivable and accrued liabilities approximate fair value. ASC Topic 820 defines fair value as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, ASC Topic 820 establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of inputs used to measure fair value are as follows:

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

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



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

In January 2010, the Financial Accounting Standards Board ( FASB ) issued guidance related to fair value disclosure requirements. The new guidance resulted in a change in the Company's accounting policy effective March 1, 2010. Under this guidance, companies will be required to make additional disclosures concerning significant transfers of amounts between the Level 1 and Level 2 fair value disclosures, as well as further disaggregation of the types of activity that were previously disclosed in the rollforward of Level 3 fair value disclosures. Further, the guidance clarifies the level of aggregation of assets and liabilities within the fair value hierarchy that may be presented. The adoption of this guidance did not have an impact on the Company's consolidated financial statements.

The following table summarizes our financial assets and liabilities measured and reported in the Company's statement of financial position at fair value on a recurring basis as of February 29, 2012, segregated among the appropriate levels within the fair value hierarchy:

	Quoted prices in active markets for identical (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable (Level 3)
<b>Assets</b>			
Investments available-for-sale	\$	\$ 18,281,129	\$
Trading securities	1,424,399		

The Company's investments in Level 1 are in equity stocks at a cost of \$1,967,570. The Company's investments in Level 2 are in perpetual bonds traded on the European markets, at a cost of \$8,435,146.

**Foreign Currency Translation**

The functional currency of the Company as a whole is the U.S. Dollar. The Company has designated the Chinese Yuan Renminbi as the functional currency for its subsidiaries in mainland China, and the U.S. Dollar for Sino Bond in Hong Kong. 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.

**Revenue Recognition***Background*

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

*Revenue Recognition Policy*

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

*Contractual Allowance*

The Company computes its contractual allowance based on the estimated collections on its gross billed charges. The Company computes its estimate by taking into account collections received, up to 30 days after the end of the

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period, for the services performed and also estimating amounts collectible for the services performed within the last six months. The following table shows gross revenues and contractual allowances for the three and six months ended February 29, 2012 and February 28, 2011:

	Three months ended		Six months ended	
	February 29, 2012	February 28, 2011	February 29, 2012	February 28, 2011
Gross billed charges	\$ 3,692,503	\$ 4,954,275	\$ 8,746,618	\$ 10,924,743
Contractual allowance	2,725,787	3,265,462	5,934,929	6,786,115
Net revenue	\$ 966,716	\$ 1,688,813	\$ 2,811,689	\$ 4,138,628
Contractual allowance percentage	74%	66%	68%	62%

A significant amount of our net revenue results from Texas workers' compensation claims, which are governed by the rules and regulations of the Texas Department of Workers' Compensation (TDWC) and the workers' compensation healthcare networks. If our hospital chooses to participate in a network, the amount of revenue that will be generated from workers' compensation claims will be governed by the network contract.

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

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

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

A petition asking the Texas Supreme Court to review the Third Court of Appeals decision has been denied. Therefore, the Company is bound by the Third Court of Appeals decision. The Texas Supreme Court's decision has further delayed final adjudication in these pending stop-loss cases. The uncertain outcome in these cases will depend on a very lengthy process. We anticipate further, lengthy litigation at the Travis County District Courts and the Texas Courts of Appeals. Because of this lengthy process and the uncertainty of recovery in these cases, collection of a material amount of funds in these pending stop-loss cases is not anticipated during the 2012 fiscal year.

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Through February 2012, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately \$11 million in claims. In most of these cases, the carriers have requested refunds of the payments made in the event that the SOAH decisions and orders are reversed on appeal. Our request that the TDWC Commissioner enforce the awards which were not voluntarily paid by the carriers was refused in approximately 130 cases. Motions filed seeking a refund in some cases in which the awards were voluntarily paid have been granted and the Company has been ordered to refund approximately \$3.7 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. In September and October 2011, the Company deposited these amounts as cash deposits into the registry of the court in order to stay execution of the judgments ordering refunds. We anticipate that similar motions requesting remand and a refund for awards voluntarily paid will be filed and will likely be granted by the 345th Judicial District Court of Travis County, Texas. If and when these additional motions are granted, the Company will be ordered to refund an additional \$7.7 million, not including prejudgment interest. The Company has appealed the judgments requiring a refund to the carriers. The appeal of the refund judgments will progress simultaneously to the adjudication of those cases remanded for determinations of whether the services provided were unusually costly and unusually extensive. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and will likely be ordered to be refunded. Once the Company is given the opportunity to present its evidence regarding whether the services provided were unusually costly and unusually extensive, the Company anticipates that it will prevail in the underlying stop-loss fee disputes and that voluntary payments refunded to the carriers will be recaptured.

Due to the uncertainties associated with these stop-loss fee dispute cases, in fiscal year 2011, the Company recognized an increase of \$10,254,990 in the contractual allowance at our Pasadena facility (and an additional loss of \$779,583 in the contractual allowance at our Garland facility, which is classified as discontinued operations), and \$1,751,478 in interest expense at our Pasadena facility (and an additional interest expense of \$132,339 at our Garland facility).

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 basis for reimbursement for these services made the subject of these pending cases is the determination of fair and reasonable charges. In 2007, we received unfavorable rulings from SOAH in all of our appeals of unfavorable decisions related to services provided in 2001 and 2002. The 179 cases, which were appealed to the Travis County district courts, challenged the constitutionality of the relevant statutory language. The Company received an unfavorable ruling in its lead case in March 2009, which ruling was appealed to and was upheld by the Third Court of Appeals on August 26, 2010. The Texas Supreme Court denied a petition asking for review of the Third Court of Appeals decision. The unfavorable interpretation by the Texas Court of Appeal in our lead case negatively affects the recovery of additional reimbursement, not only in the lead case, but in the remaining 178 cases. Consequently, the Company is bound by the Third Court of Appeals ruling that interprets the applicable statute and fee guideline to require that the amount that will be paid to a provider must not only be at a fair and reasonable rate but also must ensure the quality of medical care and achieve effective cost control and be the same or less than that charged to others with an equivalent standard of living. This ruling will impact cases in which a fee guideline was not applicable, specifically all pending cases involving ambulatory surgical services provided in 2001 and 2002 as well as all pending cases involving hospital outpatient services provided prior to March 1, 2008, when the Guidelines took effect. Since the Third Court of Appeals unfavorable ruling, collection, if any, in these cases depends on the Company's ability to establish the criteria in this ruling. The Company anticipates that it will be given the opportunity to establish the criteria in several hundred cases currently pending at SOAH during the 2012 fiscal year.

We are currently pursuing claims against two healthcare agents relating to contracts with certain of our facilities which set out reimbursement guidelines by several workers' compensation carriers at a minimum of 70% of the facility's charges. Discovery is continuing on these claims to determine which carriers are involved, the amount of reimbursement due to us, and the data used to determine usual and customary market rates for medical services in specific geographic regions.

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

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### *Accounts Receivable*

Accounts receivable represent net receivables for services provided by the Company. At each balance sheet date management reviews the accounts receivable for collectibility.

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.

### **Discontinued Operations**

#### *Revenue Recognition Policy*

In China, the local government Department of Health establishes billing rates for a hospital's sale of prescription medication and medical services. A majority of the services provided by Second People's Hospital is to cash pay patients, who pay for the services in advance. For services provided under the local government's social healthcare insurance program, we are generally paid at approximately 95% of billed charges two to three months after the date of service. The remaining 5% of billed charges is evaluated by the local government Department of Health on a semi-annual basis and may be paid to the hospital after that evaluation is complete. As of February 28, 2011, the Company made the decision to terminate the management agreement with the Rui An City Department of Health, and is currently in negotiation with them to finalize the terms, including the effective date of termination. The Company had bad debt expenses of \$-0- and \$21,991 for the three months ended February 29, 2012 and February 28, 2011, respectively, and \$-0- and \$24,755 for the six months ended February 29, 2012 and February 28, 2011, respectively, related to denials under the social healthcare insurance program. Since the amount of bad debt expense is minimal, it has been included with Other Operating Expenses in the income statement.

### **Noncontrolling Interest**

The equity of minority investors (minority investors are generally physician groups and other healthcare providers that perform surgeries at the Company's facilities) in certain subsidiaries of the Company is reported on the consolidated balance sheets as noncontrolling interest. Noncontrolling interest reported in the consolidated income statements reflect the respective interests in the income or loss of the limited partnerships or limited liability companies attributable to the minority investors (equity interest ranged from 1.75% to 3.00% at February 29, 2012).

### **Comprehensive Loss and Accumulated Other Comprehensive Income**

Comprehensive loss consists of net loss and other comprehensive income (loss). Other comprehensive income (loss) represents certain components of revenues, expenses, gains and losses that are included in comprehensive loss, but are excluded from net loss. Other comprehensive income (loss) amounts are recorded directly as an adjustment to stockholders' equity, net of tax, and for the three and six months ended February 29, 2012 and February 28, 2011 were as follows:

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	Three months ended		Six months ended	
	February 29, 2012	February 28, 2011	February 29, 2012	February 28, 2011
Net loss	\$ (1,795,586)	\$ (1,677,362)	\$ (3,739,679)	\$ (2,834,002)
Other comprehensive income (loss), net of taxes:				
Foreign currency translation adjustment, net of taxes of \$(10,246), \$68,535, \$(13,344) and \$166,069, respectively	(19,029)	117,242	(24,782)	308,413
Reclassification adjustment for foreign currency gains included in net income, net of taxes of \$(384,283), \$-0-, \$(501,273) and \$-0-, respectively	(704,051)		(921,318)	
Change in valuation of investment available-for-sale, net of taxes of \$1,293,508, \$369,802, \$(97,599) and \$358,550, respectively	2,402,230	686,773	(181,256)	665,877
Total other comprehensive loss, net of taxes	(116,436)	(873,347)	(4,867,035)	(1,859,712)
Comprehensive loss attributable to the noncontrolling interest				
Comprehensive loss attributable to Dynacq Healthcare, Inc.	\$ (116,436)	\$ (873,347)	\$ (4,867,035)	\$ (1,859,712)

The components of accumulated other comprehensive income were as follows:

	February 29, 2012	August 31, 2011
Foreign currency translation adjustment, net of taxes of \$3,600 and \$518,217, respectively	\$ 6,682	\$ 952,782
Change in valuation of investment available-for-sale, net of taxes of \$3,402,882 and \$3,500,481, respectively	6,319,638	6,500,894
Total accumulated other comprehensive income, net of taxes of \$3,406,482 and \$4,018,698, respectively	\$ 6,326,320	\$ 7,453,676

**Contingencies**

Due to the uncertainties associated with the stop-loss fee dispute cases, the Company has recognized, in fiscal year 2011, an increase of \$12.9 million in the contractual allowance and related interest expense at our Pasadena and Garland facilities. For a detailed discussion of this, see Revenue Recognition Policy under Notes to Consolidated Financial Statements. Motions filed seeking a refund in some cases in which the awards were voluntarily paid have been granted and the Company has been ordered to refund approximately \$3.7 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. In September and October 2011, the Company deposited these amounts as cash deposits into the registry of the court in order to stay execution of the judgments ordering refunds. We anticipate that similar motions requesting remand and a refund for awards voluntarily paid will be filed and will likely be granted by the 345th Judicial District Court of Travis County, Texas. If and when these additional motions are granted, the Company will be ordered to refund an additional \$7.7 million, not including prejudgment interest. The Company has appealed the judgments requiring a refund to the carriers. The appeal of the refund judgments will progress simultaneously to the adjudication of those cases remanded for determinations of whether the services provided were unusually costly and unusually extensive. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and will likely be ordered to be refunded. Once the Company is given the opportunity to present its evidence regarding whether the services provided were unusually costly and unusually extensive, the Company anticipates that it will prevail in the underlying stop-loss fee disputes and that voluntary payments refunded to the carriers will be recaptured.

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

The management agreement for the Second People's Hospital required that 1% of the drug income, and drug income in excess of 40% of total sales, of the hospital be paid to the government. This requirement was designed to control the cost of drugs by discouraging the sale by the hospital of drugs purchased from other than approved drug vendors. However, the local government has not published a list of approved drug vendors and therefore has not enforced the payment provision since the inception of the original management agreement. The Company has been advised by a local attorney that enforcement of that provision is remote, so it has not accrued the amount that would be payable to the local government if this provision were enforced. If the government were to enforce this provision, Dynacq-Huai-Bei could potentially owe approximately \$1.6 million to the government for the period of time since inception of the original management contract on the hospital to February 29, 2012.

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

## **Industry Segments and Geographic Information**

The Industry Segment U.S. Division comprises of the Company's Pasadena facility. In the prior year it was classified as discontinued operations in the consolidated financial statements. The Company at the present time has the U.S. Division and the Corporate Division.

Certain previously reported financial information has been reclassified to conform to the current year's presentation. The impact of such reclassification was not significant to the prior year's overall presentation, except for (1) presenting the Pasadena facility as continuing operations under U.S. Division, which was presented in the prior year as discontinued operations, and (2) the presentation of the various subsidiaries (except for Dynacq-Huai Bei and Sino Bond, which are now shown as part of the Corporate Division) in China as discontinued operations under the Corporate Division, which in the previous year was shown as part of continuing operations under the China Division.

The Company had made the decision to sell its Garland facility as of August 31, 2010, and its operation was classified as discontinued operations for the year ended August 31, 2010. However, the Company closed the Garland facility on September 30, 2011, and accordingly its operations for the fiscal years 2011 and 2012 continue to be classified as Discontinued Operations (see Discontinued Operations below). The Company plans to either sell the Garland facility or pursue converting it into an ambulatory surgical center, if and when the Company can identify and generate a steady referral source for outpatient cases. The Company intended to sell its Pasadena facility also, and had it classified as discontinued operations, as of August 31, 2010. However, since a sale was not consummated during the 12-month period following the decision to sell, the operations of the Pasadena facility have been reclassified as continuing operations for the fiscal years 2011 and 2012. The Company is continuing to revamp its operations at the Pasadena facility by modifying the business model and controlling expenses. However, there can be no assurance that we will be successful in turning the facility around.

From March 1, 2009 to February 28, 2011, Dynacq Huai Bei Healthcare, Inc. (Dynacq-Huai Bei), a wholly owned subsidiary of the Company provided healthcare management services to the Second People's Hospital in Rui An, China. The Company organized Dynacq-Huai Bei in April 2008 under the laws of the People's Republic of China. Dynacq-Huai Bei was responsible for funding any operating deficits, and was entitled to any operating profits, of that hospital during the management period. Due to continued losses at the Second People's Hospital,

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the Company made the decision to terminate the management agreement with the Rui An City Department of Health, and is currently in negotiation with them to finalize the terms, including the effective date of termination. The Company ceased providing healthcare management services to the Second People's Hospital as of February 28, 2011. The Company has written off the fixed assets and inventory balances as of February 28, 2011, and does not expect any further losses due to the termination of this management agreement related to the Second People's Hospital. We have accounted for the operations of the Second People's Hospital in Rui An, China as discontinued operations, and have reclassified prior period financial statements to exclude them from continuing operations.

Dynacq-Huai Bei and the Rui An City Department of Health had also previously entered into an agreement assigning to Dynacq-Huai Bei the right to manage the Third People's Hospital in Rui An, which hospital is currently under construction. Dynacq-Huai Bei and the Rui An City Department of Health, in November 2010, mutually agreed to terminate this agreement, due to continued delays in the construction of the Third People's Hospital. Accordingly, Dynacq-Huai Bei will not be managing the Third People's Hospital.

The Company has also organized Sino Bond Inc. Limited, a Hong Kong corporation (Sino Bond) to hold and manage investments in Hong Kong. Sino Bond invests in debt and equity securities in Europe and Asia, including initial public offerings and pre-initial public offerings.

At the present time, the Company's subsidiaries in China and Hong Kong are not pursuing any new line of business and/or projects.

The Company has invested in various bonds. These investments are classified as available-for-sale securities, and are carried at fair value as of February 29, 2012, based on the quoted market prices as of that date. As of February 29, 2012, these securities are valued at approximately \$18.3 million. The Company intends to hold these for a minimum period of an additional 12 months. During the three months ended February 29, 2012 and February 28, 2011, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had gains of \$108,491 and \$69,584, respectively. During the six months ended February 29, 2012 and February 28, 2011, the trading in initial public offerings of equity securities on the Hong Kong Stock Exchange generated losses of \$57,101 and \$14,995, respectively. The Company, through a subsidiary in Hong Kong, has expanded its investments in debt and equity securities in Europe and Asia and has engaged the services of an investment banker to recommend such investment opportunities. The Company's primary investment focus will be on growth companies from mainland China. The Company anticipates making short-term investments in these entities through initial public offerings (held mostly through the Hong Kong Stock Exchange) and pre-initial public offerings.

## **Discontinued Operations**

On September 29, 2011, the Board of Directors of the Company approved the closure of the Garland facility, included in our U.S. division, effective September 30, 2011. Prior to that, in August 2010, the Board of Directors of the Company had approved a plan to dispose of the Garland facility due to continued operating losses. The Garland facility had experienced decreases in net patient revenues and number of cases, generally attributable to the loss of physicians from our medical staff. The opening of a new hospital near our Garland facility has had a direct adverse impact on our ability to retain members of the medical staff at that facility and consequently on our patient volume. The Garland facility was operating at a loss, and the Board of Directors believes that ceasing operations of the facility at this time is in the Company's best interest. The Company has estimated a closing cost of \$625,000. However, the ongoing losses incurred will be reduced due to the closing of the facility.

The Company had an independent appraisal done in October 2011 for both the hospitals, and based on each hospital's valuation, expected sale proceeds, and expected cash flows has determined that there is no impairment charge required in connection with the foregoing disposal activities.

The Company has discontinued operations of all its foreign subsidiaries, except for Dynacq-HuaiBei and Sino Bond, and has either closed or is in the process of closing them.

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

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

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

	Three months ended		Six months ended	
	February 29, 2012	February 28, 2011	February 29, 2012	February 28, 2011
<b><u>Revenues from external customers</u></b>				
<b>Net patient service revenues</b>				
U.S. Division	\$ 966,716	\$ 1,688,813	\$ 2,811,689	\$ 4,138,628
Corporate				
Consolidated	\$ 966,716	\$ 1,688,813	\$ 2,811,689	\$ 4,138,628
<b><u>Income (loss) before taxes and discontinued operations</u></b>				
U.S. Division	\$ (1,584,878)	\$ (593,099)	\$ (1,989,527)	\$ (513,394)
Corporate	132,035	(742,186)	(872,258)	(1,483,564)
Consolidated	\$ (1,452,843)	\$ (1,335,285)	\$ (2,861,785)	\$ (1,996,958)

	February 29, 2012	August 31, 2011
<b><u>Total Assets</u></b>		
U.S. Division	\$ 8,416,886	\$ 8,763,015
Corporate	41,530,838	50,550,958
Assets of continuing operations	49,947,724	59,313,973
Assets of discontinued operations	6,651,726	6,909,527
Consolidated	\$ 56,599,450	\$ 66,223,500

**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, 2011. 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, 2011.

**Update on Critical Accounting Policies and Estimates**



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There have been no changes to the critical accounting policies used in our reporting of results of operations and financial position for the three months ended February 29, 2012. 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, 2011.

**Table of Contents****Results of Operations**

	Thee Months Ended February 29, 2012			Three Months Ended February 28, 2011		
	U.S. Division	Corporate	Total	U.S. Division	Corporate	Total
Net patient service revenue	\$ 966,716	\$	\$ 966,716	\$ 1,688,813	\$	\$ 1,688,813
Costs and expenses:						
Compensation and benefits	964,412	1,054,900	2,019,312	1,049,769	555,126	1,604,895
Medical services and supplies	343,508		343,508	365,464		365,464
Other operating expenses	990,283	359,053	1,349,336	887,927	662,324	1,550,251
Depreciation and amortization	115,206	45,081	160,287		44,109	44,109
Total costs and expenses	2,413,409	1,459,034	3,872,443	2,303,160	1,261,559	3,564,719
Operating loss	(1,446,693)	(1,459,034)	(2,905,727)	(614,347)	(1,261,559)	(1,875,906)
Other income (expense):						
Rent and other income	2,110	1,255,734	1,257,844	28,013	168,595	196,608
Interest income		338,305	338,305		353,763	353,763
Interest expense	(140,295)	(2,970)	(143,265)	(6,765)	(2,985)	(9,750)
Total other income (expense), net	(138,185)	1,591,069	1,452,884	21,248	519,373	540,621
Income (loss) before income taxes from continuing operations	\$ (1,584,878)	\$ 132,035	(1,452,843)	\$ (593,099)	\$ (742,186)	(1,335,285)
Benefit for income taxes						493,030
Loss from continuing operations			(1,452,843)			(842,255)
Discontinued operations, net of income taxes			(169,547)			(715,258)
Loss on disposal of discontinued operations, net of income taxes			(229,201)			(121,577)
Net loss			(1,851,591)			(1,679,090)
Less: Net loss attributable to noncontrolling interest			56,005			1,728
Net loss attributable to Dynacq Healthcare, Inc.			\$ (1,795,586)			\$ (1,677,362)
Operational statistics (Number of medical procedures) for Pasadena facility:						
Inpatient:						
Bariatric	13			17		
Orthopedic				7		
Other	14			4		
Total inpatient procedures	27			28		
Outpatient:						
Orthopedic	28			19		
Other	93			117		

Total outpatient procedures	121	136
Total procedures	148	164

**Table of Contents****Results of Operations (continued)**

	Six Months Ended February 29, 2012			Six Months Ended February 28, 2011		
	U.S. Division	Corporate	Total	U.S. Division	Corporate	Total
Net patient service revenue	\$ 2,811,689	\$	\$ 2,811,689	\$ 4,138,628	\$	\$ 4,138,628
Costs and expenses:						
Compensation and benefits	1,929,426	1,767,255	3,696,681	2,206,090	1,397,753	3,603,843
Medical services and supplies	566,626		566,626	784,020		784,020
Other operating expenses	1,803,519	868,606	2,672,125	1,686,965	1,667,223	3,354,188
Depreciation and amortization	224,638	85,460	310,098		90,954	90,954
Total costs and expenses	4,524,209	2,721,321	7,245,530	4,677,075	3,155,930	7,833,005
Operating loss	(1,712,520)	(2,721,321)	(4,433,841)	(538,447)	(3,155,930)	(3,694,377)
Other income (expense):						
Rent and other income	11,811	1,248,631	1,260,442	38,999	938,267	977,266
Interest income		606,203	606,203		740,453	740,453
Interest expense	(288,818)	(5,771)	(294,589)	(13,946)	(6,354)	(20,300)
Total other income (expense), net	(277,007)	1,849,063	1,572,056	25,053	1,672,366	1,697,419
Loss before income taxes from continuing operations	\$ (1,989,527)	\$ (872,258)	(2,861,785)	\$ (513,394)	\$ (1,483,564)	(1,996,958)
Benefit for income taxes						666,679
Loss from continuing operations			(2,861,785)			(1,330,279)
Discontinued operations, net of income taxes			(732,213)			(1,384,909)
Loss on disposal of discontinued operations, net of income taxes			(229,201)			(121,577)
Net loss			(3,823,199)			(2,836,765)
Less: Net loss attributable to noncontrolling interest			83,520			2,763
Net loss attributable to Dynacq Healthcare, Inc.			\$ (3,739,679)			\$ (2,834,002)
Operational statistics (Number of medical procedures) for Pasadena facility:						
Inpatient:						
Bariatric	30			36		
Orthopedic	1			14		
Other	45			8		
Total inpatient procedures	76			58		
Outpatient:						
Orthopedic	53			43		
Other	173			262		

Total outpatient procedures	226	305
Total procedures	302	363

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*Three Months Ended February 29, 2012 Compared to the Three Months Ended February 28, 2011*

### **U.S. Division**

Through February 29, 2012, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately \$11 million in claims. In most of these cases, the carriers have requested refunds of the payments made in the event that the SOAH decisions and orders are reversed on appeal. Our request that the TDWC Commissioner enforce the awards which were not voluntarily paid by the carriers was refused in approximately 130 cases. Motions filed seeking a refund in some cases in which the awards were voluntarily paid have been granted and the Company has been ordered to refund approximately \$3.7 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. In September and October 2011, the Company deposited these amounts as cash deposits into the registry of the court in order to stay execution of the judgments ordering refunds. We anticipate that similar motions requesting remand and a refund for awards voluntarily paid will be filed and will likely be granted by the 345th Judicial District Court of Travis County, Texas. If and when these additional motions are granted, the Company will be ordered to refund an additional \$7.7 million, not including prejudgment interest. The Company has appealed the judgments requiring a refund to the carriers. The appeal of the refund judgments will progress simultaneously to the adjudication of those cases remanded for determinations of whether the services provided were unusually costly and unusually extensive. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and will likely be ordered to be refunded. Once the Company is given the opportunity to present its evidence regarding whether the services provided were unusually costly and unusually extensive, the Company anticipates that it will prevail in the underlying stop-loss fee disputes and that voluntary payments refunded to the carriers will be recaptured.

Due to the uncertainties associated with these stop-loss fee dispute cases, in fiscal year 2011, the Company recognized an increase of \$10,254,990 in the contractual allowance at our Pasadena facility (and an additional loss of \$779,583 in the contractual allowance at our Garland facility, which is classified as discontinued operations), and \$1,751,478 in interest expense at our Pasadena facility (and an additional interest expense of \$132,339 at our Garland facility).

Net patient service revenue decreased by \$722,097, or 43%, from \$1,688,813 to \$966,716, and total surgical cases decreased by 10% from 164 cases for the three months ended February 28, 2011 to 148 cases for the three months ended February 29, 2012. While the number of cases decreased by 10%, net patient service revenue decreased by 43%. The change in percentage decrease in net patient service revenue compared to the decrease in the number of cases is primarily due to a change in the surgical mix of cases. Decreases in net patient revenues and number of cases are generally attributable to the loss of physicians from our medical staff.

Total costs and expenses increased by \$110,249, or 5%, from \$2,303,160 for the three months ended February 28, 2011 to \$2,413,409 for the three months ended February 29, 2012. The following discusses the various changes in costs and expenses:

Compensation and benefits decreased by \$85,357, or 8%, primarily associated with reduction in workforce due to lower net patient service revenues.

Medical services and supplies expenses decreased by \$21,956, or 6%, while the number of surgery cases decreased 10%. The percentage decrease in medical services and supplies was marginally lower than the percentage decrease in the number of surgery cases due to a change in the surgical mix of cases.

Other operating expenses increased by \$102,356, or 12%. The Company is trying to revamp its Pasadena facility operations and thus has a marginal increase in its other operating expenses, including marketing and legal fees.

Depreciation and amortization expenses increased by \$115,206 in 2012 compared to 2011. The Company had ceased depreciating property and equipment for its Pasadena facility in the prior year since it was

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classified as discontinued operations, and was being measured at the lower of its carrying amount or fair value less cost to sell.

However, in the current year, the Pasadena facility's operations are classified as continuing operations, and thus its property and equipment are being depreciated.

Other income (expense) for the three months ended February 29, 2012 of \$(138,185) includes interest expense of \$140,295 primarily associated with the stop-loss cases discussed above.

## Corporate Division

Compensation and benefits includes all corporate personnel compensation and benefits, and it increased by \$499,774, or 90%, in 2012, compared to 2011. The increase in compensation and benefits was due to the following reasons: (1) for the three months ended February 29, 2012, there was a non-cash compensation expense of \$82,244, related to employees' incentive stock options granted in fiscal years 2007, 2011 and 2012. However, for the three months ended February 28, 2011, due to the non-cash compensation expense true-up in 2011 based on forfeiture of incentive stock options, the expense was \$(102,963), (2) during the current fiscal year, the Company issued 50,000 shares of its common stock to Dr. Kelly Larkin as consideration for Dr. Larkin's employment as the Company's marketing director, and took a compensation charge of \$50,000 related to the issuance, (3) the Company has retained the services of Dr. Eric Chan, as its chief executive officer starting January 10, 2012, (4) the chief financial officer of the Company had a reduction in his compensation for part of the three months in 2011, whereas for the three months in 2012, the Compensation Committee reinstated his compensation to \$200,000, effective February 1, 2012, and paid him a sum of \$77,000, which equates to the prior reductions in his compensation from January 1, 2010 to January 31, 2012. The Committee recognized that he has been working above and beyond the norm to revive the Company's business including actively working on several special projects and that he has further been instrumental in providing the continuity in management during the transition of the Company's new chief executive officer, and (5) the Company continues to make efforts to increase its net patient service revenues and has hired various marketing personnel during the three months ended February 29, 2012.

Other operating expenses includes primarily administrative expenses for managing the various projects the Company was undertaking in China and Hong Kong, related marketing expenses and rent for an apartment for our chief executive officer in Hong Kong. The Company has made the decision to not pursue any new line of business and/or projects, and has also terminated the apartment lease. Other operating expenses also includes all the corporate general and administrative expenses in the U.S., including other professional fees such as legal expenses and audit expenses. Other operating expenses decreased by \$303,271, from \$662,324 for the three months ended February 28, 2011 to \$359,053 for the three months ended February 29, 2012. For the three months ended February 28, 2011, the Company's subsidiary in Hong Kong incurred the following costs: (1) marketing fees of \$150,000, (2) rent of \$33,242 for an apartment for the Company's chief executive officer in Hong Kong, and (3) other administrative support services fees. These expenses were not incurred for the three months ended February 29, 2012. The Company also incurred lower professional fees and other miscellaneous expenses primarily associated with lower net revenues.

Rent and other income increased by \$1,087,139, from \$168,595 for the three months ended February 28, 2011 to \$1,255,734 for the three months ended February 29, 2012. Rent and other income for the three months ended February 29, 2012 includes (1) a foreign currency gain of \$1,088,333 realized due to the monies invested in China coming back to the U.S. The Company had invested in its foreign subsidiaries in China during the last few years, and due to a favorable change in exchange rates between the U.S. Dollar and the Chinese Yuan Renminbi, the Company had accumulated other comprehensive income of \$1,088,333. This amount was realized as a gain during the three months ended February 29, 2012 upon the return of investments from the Company's foreign subsidiaries in China, (2) a gain of \$108,491 due to fair valuation of trading securities as of February 29, 2012, and (3) foreign currency exchange gains of \$63,072. Rent and other income for the three months ended February 28, 2011 includes (1) foreign currency exchange gains of \$77,362, primarily on investments in Euro bonds, and (3) a gain of \$69,584 on short-term investments in trading securities in Hong Kong.

Interest income of \$338,305 and \$353,763 for the three months ended February 29, 2012 and February 28, 2011, respectively, are primarily related to the Company's investments in bonds.

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### **Investments in securities**

The Company has invested in various bonds. These investments are classified as available-for-sale securities, and are carried at fair value as of February 29, 2012, based on the quoted market prices as of that date. As of February 29, 2012, these securities are valued at approximately \$18.3 million. Unrealized gains in these investments of \$6.3 million are included in accumulated other comprehensive income in the Consolidated Balance Sheet as at February 29, 2012, net of taxes of \$3.4 million. The Company intends to hold these for a minimum period of an additional 12 months. During the three months ended February 29, 2012 and February 28, 2011, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had gains of \$108,491 and \$69,584, respectively. The Company, through a subsidiary in Hong Kong, has expanded its investments in debt and equity securities in Europe and Asia and has engaged the services of an investment banker to recommend such investment opportunities. The Company's primary investment focus will be on growth companies from mainland China. The Company anticipates making short-term investments in these entities through initial public offerings (held mostly through the Hong Kong Stock Exchange) and pre-initial public offerings.

For the three months ended February 29, 2012, the Company did not recognize any tax benefits applicable to the operating loss. The balance sheet reflects an increase in the deferred tax asset of \$612,216 due to a reduction in deferred tax liability related to the foreign currency exchange gain realized.

### **Discontinued Operations**

#### **Garland Facility (discontinued operations)**

Due to the uncertainties associated with the stop-loss fee dispute cases discussed above, in fiscal year 2011, the Company recognized an increase of \$779,583 in the contractual allowance, and an additional interest expense of \$132,339, at our Garland facility.

The Company closed the Garland facility on September 30, 2011, and accordingly its operations for the fiscal years 2011 and 2012 continue to be classified as discontinued operations. The Company plans to either sell the Garland facility or pursue converting it into an ambulatory surgical center, if and when the Company can identify and generate a steady referral source for outpatient cases. Net patient service revenue decreased by \$640,827, from \$734,538 to \$93,711, due to the closure of the facility on September 30, 2011.

Total costs and expenses decreased by \$1,315,961, from \$1,568,908 for the three months ended February 28, 2011 to \$252,947 for the three months ended February 29, 2012, due to the closure of the facility on September 30, 2011.

#### **Corporate (discontinued operations)**

The Corporate Division revenue includes net patient service revenues from Second People's Hospital in Rui An, China. Due to continued losses at the Second People's Hospital, the Company made the decision to terminate the management agreement as of February 28, 2011 with the Rui An City Department of Health, and is currently in negotiation with them to finalize the terms, including the effective date of termination. The loss before income taxes at the Second People's Hospital for the three months ended February 28, 2011 was \$343,612, which includes a loss before income taxes of \$187,041 for disposal of the hospital.

The Corporate Division also includes other operating expenses the Company incurred at certain of its subsidiaries in China while pursuing various projects. All of the Company's foreign subsidiaries, except for Dynacq-Huai Bei and Sino Bond, have been reclassified as discontinued operations. The Company incurred \$-0- and \$161,738 in total costs and expenses at these subsidiaries during the three months ended February 29, 2012 and February 28, 2011, respectively. Loss before income taxes in these subsidiaries was \$-0- and \$106,679 for the three months ended February 29, 2012 and February 28, 2011, respectively. In addition, loss on disposal of discontinued operations in China was \$229,201 for the three months ended February 29, 2012.



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*Six Months Ended February 29, 2012 Compared to the Six Months Ended February 28, 2011*

### **U.S. Division**

Through February 29, 2012, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately \$11 million in claims. In most of these cases, the carriers have requested refunds of the payments made in the event that the SOAH decisions and orders are reversed on appeal. Our request that the TDWC Commissioner enforce the awards which were not voluntarily paid by the carriers was refused in approximately 130 cases. Motions filed seeking a refund in some cases in which the awards were voluntarily paid have been granted and the Company has been ordered to refund approximately \$3.7 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. In September and October 2011, the Company deposited these amounts as cash deposits into the registry of the court in order to stay execution of the judgments ordering refunds. We anticipate that similar motions requesting remand and a refund for awards voluntarily paid will be filed and will likely be granted by the 345th Judicial District Court of Travis County, Texas. If and when these additional motions are granted, the Company will be ordered to refund an additional \$7.7 million, not including prejudgment interest. The Company has appealed the judgments requiring a refund to the carriers. The appeal of the refund judgments will progress simultaneously to the adjudication of those cases remanded for determinations of whether the services provided were unusually costly and unusually extensive. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and will likely be ordered to be refunded. Once the Company is given the opportunity to present its evidence regarding whether the services provided were unusually costly and unusually extensive, the Company anticipates that it will prevail in the underlying stop-loss fee disputes and that voluntary payments refunded to the carriers will be recaptured.

Due to the uncertainties associated with these stop-loss fee dispute cases, in fiscal year 2011, the Company recognized an increase of \$10,254,990 in the contractual allowance at our Pasadena facility (and an additional loss of \$779,583 in the contractual allowance at our Garland facility, which is classified as discontinued operations), and \$1,751,478 in interest expense at our Pasadena facility (and an additional interest expense of \$132,339 at our Garland facility).

Net patient service revenue decreased by \$1,326,939, or 32%, from \$4,138,628 to \$2,811,689, and total surgical cases decreased by 17% from 363 cases for the six months ended February 28, 2011 to 302 cases for the six months ended February 29, 2012. While the number of cases decreased by 17%, net patient service revenue decreased by 32%. The change in percentage decrease in net patient service revenue compared to the decrease in the number of cases is primarily due to a change in the surgical mix of cases. Decreases in net patient revenues and number of cases are generally attributable to the loss of physicians from our medical staff.

Total costs and expenses decreased by \$152,866, or 3%, from \$4,677,075 for the six months ended February 28, 2011 to \$4,524,209 for the six months ended February 29, 2012. The following discusses the various changes in costs and expenses:

Compensation and benefits decreased by \$276,664, or 13%, primarily associated with reduction in workforce due to lower net patient service revenues.

Medical services and supplies expenses decreased by \$217,394, or 28%, while the number of surgery cases decreased 17%. The percentage decrease in medical services and supplies was higher than the percentage decrease in the number of surgery cases due to a change in the surgical mix of cases.

Other operating expenses increased by \$116,554, or 7%. The Company is trying to revamp its Pasadena facility operations and thus has a marginal increase in its other operating expenses, including marketing and legal fees.

Depreciation and amortization expenses increased by \$224,638 in 2012 compared to 2011. The Company had ceased depreciating property and equipment for its Pasadena facility in the prior year since it was classified as discontinued operations, and was being measured at the lower of its carrying amount or fair value less cost to sell. However, in the current year, the Pasadena facility's operations are classified as continuing operations, and thus its property and equipment are being depreciated.



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Other income (expense) for the six months ended February 29, 2012 of \$(277,007) includes interest expense of \$288,818 primarily associated with the stop-loss cases discussed above.

### Corporate Division

Compensation and benefits includes all corporate personnel compensation and benefits, and it increased by \$369,502, or 26%, in 2012, compared to 2011. The increase in compensation and benefits was due to the following reasons: (1) for the six months ended February 29, 2012, there was a non-cash compensation expense of \$149,934, related to employees' incentive stock options granted in fiscal years 2007, 2011 and 2012. However, for the six months ended February 28, 2011, due to the non-cash compensation expense true-up in 2011 based on forfeiture of incentive stock options, the expense was \$4,251, (2) during the current fiscal year, the Company issued 50,000 shares of its common stock to Dr. Kelly Larkin as consideration for Dr. Larkin's employment as the Company's marketing director, and took a compensation charge of \$50,000 related to the issuance, (3) the Company has retained the services of Dr. Eric Chan, as its chief executive officer starting January 10, 2012, (4) the chief financial officer of the Company had a reduction in his compensation for part of the six months in 2011, whereas for the six months in 2012, the Compensation Committee reinstated his compensation to \$200,000, effective February 1, 2012, and paid him a sum of \$77,000, which equates to the prior reductions in his compensation from January 1, 2010 to January 31, 2012. The Committee recognized that he has been working above and beyond the norm to revive the Company's business including actively working on several special projects and that he has further been instrumental in providing the continuity in management during the transition of the Company's new chief executive officer, and (5) the Company continues to make efforts to increase its net patient service revenues and has hired various marketing personnel during the six months ended February 29, 2012.

Other operating expenses includes primarily administrative expenses for managing the various projects the Company was undertaking in China and Hong Kong, related marketing expenses and rent for an apartment for our chief executive officer in Hong Kong. The Company has made the decision to not pursue any new line of business and/or projects, and has also terminated the apartment lease. Other operating expenses also includes all the corporate general and administrative expenses in the U.S., including other professional fees such as legal expenses and audit expenses. Other operating expenses decreased by \$798,617, from \$1,667,223 for the six months ended February 28, 2011 to \$868,606 for the six months ended February 29, 2012. For the six months ended February 28, 2011, the Company's subsidiary in Hong Kong incurred the following costs: (1) marketing fees of \$300,000, (2) rent of \$99,726 for an apartment for the Company's chief executive officer in Hong Kong, and (3) other administrative support services fees. These expenses were not incurred for the six months ended February 29, 2012. The Company also incurred lower professional fees and other miscellaneous expenses primarily associated with lower net revenues.

Rent and other income increased by \$310,364, from \$938,267 for the six months ended February 28, 2011 to \$1,248,631 for the six months ended February 29, 2012. Rent and other income for the six months ended February 29, 2012 includes (1) a foreign currency gain of \$1,422,590 realized due to the monies invested in China coming back to the U.S. The Company had invested in its foreign subsidiaries in China during the last few years, and due to a favorable change in exchange rates between the U.S. Dollar and the Chinese Yuan Renminbi, the Company had accumulated other comprehensive income of \$1,422,590. This amount was realized as a gain during the six months ended February 29, 2012 upon the return of investments from the Company's foreign subsidiaries in China, (2) a loss of \$57,101 due to fair valuation of trading securities as of February 29, 2012, and (3) foreign currency exchange losses of \$144,078, primarily on investments in Euro bonds. Rent and other income for the six months ended February 28, 2011 includes (1) a \$720,696 refund received from the Rui An City Department of Health as part of the negotiation of termination of the assignment agreement to manage the Third People's Hospital, and write-off of associated liabilities of \$43,840 (the decision to terminate the agreement was based on the continued delays in the construction of the hospital), (2) foreign currency exchange gains of \$178,877, primarily on investments in Euro bonds, and (3) a loss of \$14,995 on short-term investments in trading securities in Hong Kong.

Interest income of \$606,203 and \$740,453 for the six months ended February 29, 2012 and February 28, 2011, respectively, are primarily related to the Company's investments in bonds.

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### **Investments in securities**

The Company has invested in various bonds. These investments are classified as available-for-sale securities, and are carried at fair value as of February 29, 2012, based on the quoted market prices as of that date. As of February 29, 2012, these securities are valued at approximately \$18.3 million. Unrealized gains in these investments of \$6.3 million are included in accumulated other comprehensive income in the Consolidated Balance Sheet as at February 29, 2012, net of taxes of \$3.4 million. The Company intends to hold these for a minimum period of an additional 12 months. During the six months ended February 29, 2012 and February 28, 2011, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had losses of \$57,101 and \$14,995, respectively. The Company, through a subsidiary in Hong Kong, has expanded its investments in debt and equity securities in Europe and Asia and has engaged the services of an investment banker to recommend such investment opportunities. The Company's primary investment focus will be on growth companies from mainland China. The Company anticipates making short-term investments in these entities through initial public offerings (held mostly through the Hong Kong Stock Exchange) and pre-initial public offerings.

For the six months ended February 29, 2012, the Company did not recognize any tax benefits applicable to the operating loss. The balance sheet reflects an increase in the deferred tax asset of \$612,216 due to a reduction in deferred tax liability related to the foreign currency exchange gain realized and a decline in value of the available-for-sale securities.

### **Discontinued Operations**

#### **Garland Facility (discontinued operations)**

Due to the uncertainties associated with the stop-loss fee dispute cases discussed above, in fiscal year 2011, the Company recognized an increase of \$779,583 in the contractual allowance, and an additional interest expense of \$132,339, at our Garland facility.

The Company closed the Garland facility on September 30, 2011, and accordingly its operations for the fiscal years 2011 and 2012 continue to be classified as discontinued operations. The Company plans to either sell the Garland facility or pursue converting it into an ambulatory surgical center, if and when the Company can identify and generate a steady referral source for outpatient cases. Net patient service revenue decreased by \$969,462, from \$1,288,049 to \$318,587, due to the closure of the facility on September 30, 2011.

Total costs and expenses decreased by \$2,126,005, from \$3,093,474 for the six months ended February 28, 2011 to \$967,469 for the six months ended February 29, 2012, due to the closure of the facility on September 30, 2011.

#### **Corporate (discontinued operations)**

The Corporate Division revenue includes net patient service revenues from Second People's Hospital in Rui An, China. Due to continued losses at the Second People's Hospital, the Company made the decision to terminate the management agreement as of February 28, 2011 with the Rui An City Department of Health, and is currently in negotiation with them to finalize the terms, including the effective date of termination. The loss before income taxes at the Second People's Hospital for the six months ended February 28, 2011 was \$368,553.

The Corporate Division also includes other operating expenses the Company incurred at certain of its subsidiaries in China while pursuing various projects. All of the Company's foreign subsidiaries, except for Dynacq-Huai Bei and Sino Bond, have been reclassified as discontinued operations. The Company incurred \$126,179 and \$233,131 in total costs and expenses at these subsidiaries during the six months ended February 29, 2012 and February 28, 2011, respectively. Loss before income taxes in these subsidiaries was \$62,275 and \$137,746 for the six months ended February 29, 2012 and February 28, 2011, respectively. In addition, loss on disposal of discontinued operations in China was \$229,201 for the six months ended February 29, 2012.

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### **Liquidity and Capital Resources**

Our 2011 Annual Report on Form 10-K includes a detailed discussion of our liquidity, contractual obligations and commitments. The information presented below updates and should be read in conjunction with the information disclosed in that Form 10-K.

#### *Cash flows from operating activities*

Cash flow used in operating activities for continuing activities was \$7,958,478 during the six months ended February 29, 2012, primarily due to a net loss before discontinued operations of \$2,778,265, net changes in income tax related accounts of \$1,655,662 and decreases in accounts payable and accrued liabilities of \$5,138,154, of which a decrease of \$3,703,252 was due to cash deposits made by the Company into the registry of the court in order to stay execution of the judgments ordering refunds in the stop-loss fee dispute cases. These decreases were partially offset by reduction in accounts receivable of \$691,455, and depreciation and amortization of \$310,098.

In addition, cash flow used in operating activities for discontinued operations was \$696,218 during the six months ended February 29, 2012, primarily due to a net loss from discontinued operations of \$961,414, partially offset by a reduction in inventories of \$260,020.

Total cash flow used in operating activities for continuing and discontinued operations combined was \$8,654,696 during the six months ended February 29, 2012.

#### *Cash flows from investing activities*

Cash flow used in investing activities for continuing activities was \$157,753 for purchase of equipment at the Pasadena facility.

#### *Cash flows from financing activities*

Cash flow provided by financing activities for continuing activities was \$109,463. In November 2011, the Company borrowed \$116,339 as note payable from a financial institution at an interest rate of 4.5%. This note payable is to be repaid in 36 monthly installments and is secured by specific equipment purchased at our Pasadena facility. The Company has paid \$28,683 during the six months ended February 29, 2012 towards notes payable for equipment purchased. In addition, the Company paid \$32,090 towards a mortgage loan for the purchase of an apartment in Hong Kong. During the six months ended February 29, 2012, the Company received contributions of \$100,000 for sale of non-controlling interests in our Pasadena facility's operations.

The Company had working capital of \$11,132,892 as of February 29, 2012 and maintained a liquid position by a current ratio of approximately 1.7 to 1.

We believe we will be able to meet our ongoing liquidity and cash needs for fiscal year 2012 through the combination of available cash and cash flow from operations.

### **Recent Accounting Pronouncements**

*Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities:* In July 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*, which requires health care entities to change the presentation in their statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). The guidance provided in this ASU is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011, with early adoption permitted. The Implementation of this standard has had no impact on our consolidated financial position or results of operations.

*Presentation of Insurance Claims and Related Insurance Recoveries:* In August 2010, the FASB issued ASU 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries*, which clarifies that a health care entity should not net insurance recoveries against a related claim liability. The guidance provided in this ASU is effective for the fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this standard has had no impact on our consolidated financial position or results of operations.



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*Fair Value Measurements and Disclosures:* The Financial Accounting Standards Board ( FASB ) has issued ASU No. 2010-06, Fair Value Measurements and Disclosures about Fair Value Measurements. ASU 2010-06 affects all entities that are required to make disclosures about recurring and nonrecurring fair value measurements under FASB ASC Topic 820, originally issued as FASB Statement No. 157, Fair Value Measurements. This ASU requires certain new disclosures and clarifies two existing disclosure requirements. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. ASU No. 2010-06 did not have a significant impact on our disclosures, and the disclosures related to the roll forward of activity in Level 3 fair value measurements did not have an impact on our disclosures.

*Presentation of Comprehensive Income:* In June 2011, the FASB amended its guidance governing the presentation of comprehensive income. The amended guidance eliminates the option to report other comprehensive income and its components in the statement of changes in equity. Under the new guidance, an entity can elect to present items of net income and other comprehensive income in one continuous statement referred to as the statement of comprehensive income or in two separate, but consecutive, statements. While the options for presenting other comprehensive income change under the guidance, other portions of the current guidance will not change. For public entities, these changes are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this standard is not expected to have a material impact on our consolidated financial position or results of operation.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Not required.

### **Item 4. Controls and Procedures.**

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 disclosure controls and procedures as of the end of the period covered by this report, pursuant to Exchange Act Rule 13a-15(e). Based on that evaluation, our chief executive officer and chief financial officer concluded that, as of February 29, 2012, our disclosure controls and procedures were effective.

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

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

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Because of these inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

The Company is routinely involved in litigation and administrative proceedings that are incidental to its business. Specifically, all judicial review of unsatisfactory determinations of reimbursement amounts due us for our Texas facilities' fees must be made in the district courts of Travis County, Texas in what can often be a lengthy procedure. Please refer to Revenue Recognition, as well as Business - Government Regulation - Texas Workers' Compensation Systems in our Form 10-K for the fiscal year ended August 31, 2011, 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, 2011 have not materially changed.

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

On January 26, 2012, the Company issued 50,000 shares of its common stock to Dr. Kelly Larkin as consideration for Dr. Larkin's employment as the Company's marketing director.

On February 6, 2012, the Company entered into an Incentive Stock Grant Agreement ( "Incentive Agreement" ) with Eric G. Carter, whereby he is to be issued an aggregate of 300,000 shares of the Company's common stock as consideration for securing organized, nationally recognized labor unions ( "Union Partners" ) as non-controlling interest partners in the Company's Pasadena facility ( "Partnership" ). These shares are to be issued to Mr. Carter at the rate of 33,333 shares for every one of the first nine Union Partners that join the Partnership. As of February 29, 2012, since two Union Partners have joined the Partnership, Mr. Carter was issued an aggregate of 66,666 shares of the Company's common stock. As an additional consideration, upon the execution of the Incentive Agreement, a Company affiliated with Mr. Carter was granted 1% non-controlling interest in the Pasadena facility.

The Company issued these shares to Dr. Larkin and Mr. Carter under the exemption from registration provided by Section 4(2) of the Securities Act of 1933 and the rules and regulations promulgated thereunder. The issuance did not involve a public offering based upon the following factors: (i) the issuance of the securities were isolated private transactions; (ii) a limited number of securities were issued to two offerees; (iii) there was no public solicitation; (iv) the investment intent of the offerees; (v) the offerees represented that they were an accredited investor and (vi) the restriction on transferability of the securities issued.

### **Item 3. Defaults Upon Senior Securities.**

None.

### **Item 4. Mining Safety Disclosures.**

None.

### **Item 5. Other Information.**

None.



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**Item 6. Exhibits.**

<b>EXHIBIT NO.</b>	<b>IDENTIFICATION OF EXHIBIT</b>
Exhibit 15.1	Awareness Letter of KWCO, P.C.
Exhibit 23.1	Consent of KWCO, 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.
**101.INS	XBRL Instance Document.
**101.SCH	XBRL Taxonomy Schema Document.
**101.CAL	XBRL Calculation Linkbase Document.
**101.LAB	XBRL Label Linkbase Document.
**101.PRE	XBRL Presentation Linkbase Document

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

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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: April 13, 2012

By: /s/ Eric K. Chan  
Eric K. Chan

Chief Executive Officer

(duly authorized officer)

Date: April 13, 2012

By: /s/ Philip S. Chan  
Philip S. Chan

Chief Financial Officer

(principal financial and accounting officer)

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